

Compact Development Guidance



MILLENNIUM
CHALLENGE CORPORATION

UNITED STATES OF AMERICA

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Introduction

A. Overview of the Millennium Challenge Corporation (MCC)

The Millennium Challenge Corporation (MCC) is an independent foreign assistance agency of the United States Government. MCC's mandate is to assist the world's poorest countries in reducing poverty through economic growth while strengthening good governance, economic freedom, and investments in people in those countries selected to receive its assistance.

Principles and Practices

Each year, MCC's Board of Directors selects, from among the countries that are eligible to receive MCC assistance, those countries with respect to which the United States will seek to enter into a Millennium Challenge Compact. In making these decisions, the MCC Board of Directors considers the following factors with respect to eligible countries it selects to pursue development of a compact: (i) the country's performance on a range of policy indicators; (ii) the opportunity to reduce poverty and generate economic growth; and (iii) the availability of MCC funding. Recognizing that development is achieved by a country's own efforts, policies, and people, MCC invites selected countries to identify their own priorities for achieving sustainable economic growth and poverty reduction. After working with MCC to develop preliminary analysis of its current economic and poverty reduction challenges, each country prepares a concept note and then a full project proposal on the basis of meaningful engagement with a range of stakeholders in its own society and consultations with MCC. An MCC country team works with the country to fully develop a compact program aimed at reducing poverty and generating economic growth. When development of the program is completed, it is reflected in a Millennium Challenge Compact (a *compact*) that defines responsibilities and includes clear objectives and measurable targets to assess progress. The compact also describes how the country will manage and implement its program, including how it will ensure financial accountability, transparency, and fair, open, and competitive procurement.

In this way, MCC manages the compact development process to reflect its core principles of: (i) **competitive selection** of countries based on their actual performance; (ii) a preference for **country-led solutions** to economic development and poverty reduction challenges, developed in partnership with civil society and the private sector; and (iii) a reliance on **country-led implementation** of development programs, with strong controls to ensure technical quality and to manage procurements and the expenditure of funds.

Funding Instruments

MCC provides large scale grants for programming in selected countries. MCC's grant programs seek to complement—not replace—the assistance programs provided by other international development organizations and United States Government agencies.

MCC's grant programs come in two primary forms. **Millennium Challenge Compact programs** are available to countries that meet all of MCC's eligibility requirements and are selected by the Board of Directors to develop a compact. Compact programs are generally large, five-year programs that consist of

investments designed to address one or more binding constraints to the country's potential for long-term economic growth. **Threshold programs** are available to countries that demonstrate strong commitment to MCC's principles but do not yet meet its eligibility requirements. Threshold programs are generally smaller, two-year to four-year programs that help countries move toward compact eligibility by implementing key policy and institutional reforms. Not all countries with threshold programs will become eligible or be selected to develop a compact.

Governance and Organization

MCC is overseen by a mixed, public and private Board of Directors comprised of nine (9) members who are drawn from both inside and outside the United States Government. The government members are: the Secretary of State (chair), the Secretary of the Treasury (vice chair), the United States Trade Representative, the Administrator of the United States Agency for International Development, and the Chief Executive Officer (CEO) of MCC. Four board members from outside the public sector, and with relevant international experience, are appointed by the President with the advice and consent of the United States Senate.

The CEO oversees the day-to-day operations of MCC with the assistance of a management team. The corporation's employees draw from diverse experience including work in international development agencies, government agencies, the private sector, universities, and non-government organizations.

B. Considerations for Country Eligibility

Each year, MCC's Board of Directors evaluates all low-income countries and lower-middle income countries. For the purposes of consideration for assistance, MCC defines low-income countries as the 75 countries with the lowest gross national income (GNI) per capita, and lower-middle income countries as all remaining countries with a GNI per capita that is lower than the World Bank's threshold for upper-middle income countries. Only countries that meet these income tests and are otherwise eligible to receive assistance under the laws of the United States are considered candidates for MCC assistance.

Selection Process

In evaluating each candidate country for compact eligibility, the Board of Directors is required by law to consider three factors, namely (i) the candidate country's performance on a range of important policy indicators, (ii) the opportunity to reduce poverty and to generate economic growth in the candidate country, and (iii) the availability of MCC funding. These factors are described in more detail below.

- i. **Performance on Policy Indicators:** First, the Board of Directors examines how the country performs on MCC's scorecard for the country which consists of a panel of twenty (20) independent, objective, quantifiable indicators that allow clear comparisons across countries (*scorecard*). These indicators measure the relative strength of the country's policies for encouraging economic freedom, investing in people, and ruling justly. In order to pass most indicators, a country must perform above the median score among the candidate countries in its income group during that fiscal year (or in the case of several indicators, above a minimum absolute score). And in order to pass on the scorecard overall, a country must (i) pass the indicator

for the control of corruption, (ii) pass one or both of the indicators for political rights and civil liberties, and (iii) pass at least ten (10) out of the twenty (20) indicators overall.

- ii. **Opportunity to Reduce Poverty and Generate Economic Growth:** Second, the Board of Directors looks closely at the opportunity to reduce poverty and generate economic growth in each candidate country. In doing so, the Board of Directors consults sources of both quantitative and qualitative information to better understand the conditions within each country. While the Board considers a range of other information sources depending on the country, specific areas of attention typically include better understanding the issues on, trends in, and trajectory of: the state of democratic and human rights (especially of vulnerable groups); the perspective of civil society on salient governance issues; the control of corruption and rule of law; the potential for the private sector (both local and foreign) to lead investment and growth; the levels of poverty within a country; and the country's institutional capacity. Where applicable, the Board of Directors also considers MCC's experience in a particularly country through previous work on a threshold program or an earlier compact program. This information sheds light on the probability that MCC investments in a country will lead to appreciable economic growth and reduction in poverty.
- iii. **Availability of MCC Funding:** Third, the Board of Directors looks closely at the funding available for new countries. MCC's annual budget is constrained, and at any given time, it has a pipeline of multiple countries that are simultaneously working through the compact development process. Consequently, the Board of Directors must weigh the selection of new countries against the level of funding available to develop and execute meaningful compact programs.

Standards of Selection

Generally, the Board will not select a country for compact assistance unless it is currently passing its scorecard at the time of selection. MCC's Board may nevertheless exercise discretion in how it interprets information related to each country's performance and potential.

MCC monitors the performance of each selected country throughout the year. The MCC Board of Directors has had the historical practice of "re-selecting" countries in compact development each year. While not required by statute, the Board had done so in the past to signal its support for MCC to continue developing a compact with the country. This focus on continued performance reflects MCC's expectation that each selected country maintain its commitment to good governance and continuous improvement in the environment for economic growth and poverty reduction.

If a selected country's policy performance declines as the result of significant policy changes or a reversal in reforms, regardless of whether or not the country is failing its scorecard MCC may issue a warning or may suspend or terminate eligibility for any otherwise available forms of MCC assistance.

Period of eligibility

Once MCC's Board of Directors selects an eligible country to develop a compact, the country can engage with MCC and initiate its compact development process.

Once selected, a country remains eligible for compact funding unless the Board of Directors suspends or terminates the country from eligibility for MCC assistance. MCC typically expends its available funding quickly. For that reason, it is to a selected country's advantage to maintain or improve its performance on

MCC's eligibility indicators and remain eligible to develop a compact program each fiscal year until compact signing.

Note: The information set forth in this chapter is based on MCC's fiscal year 2017 Selection Criteria and Methodology Report (SCMR), which is [available on MCC's website](#).

C. Considerations for Countries Eligible for a Subsequent Compact

MCC has the authority to enter into one or more subsequent compacts with a partner country after the expiration of its existing compact program. However, selection to develop a subsequent compact program is not automatic, and the completion of a previous compact program is no guarantee that a partner country will have a continued partnership with MCC.

MCC's Board of Directors subjects potential subsequent compact countries to more rigorous selection standards. As a result, only a small number of partner countries are selected to develop a subsequent program. For those selected, MCC also sets higher expectations for the contribution of resources by the partner country to the subsequent compact. In addition, subsequent compacts are intended only for countries that: exhibit successful performance on their previous compact; exhibit improved scorecard policy performance during the partnership; and exhibit a continued commitment to further their sector reform efforts in any subsequent partnership.

Selection Process and Standards for Eligibility

As a general rule, MCC's Board will not consider a partner country for subsequent compact selection until the existing program has been completed or is within eighteen (18) months of completion. In considering a partner country for subsequent compact selection, MCC's Board of Directors takes account of a broad array of information in the following categories:

- i. **Successful Implementation of the Previous Compact Program:** MCC's Board of Directors gives substantial weight to each potential subsequent compact country's performance during the implementation of its previous compact program and the quality of its partnership with MCC. First, the Board of Directors examines the degree to which the partner country demonstrated strong management capacity and political will, particularly in its commitment to implement the compact program faithfully and to fulfill its legal requirements. Second, the Board of Directors examines the degree to which the partner country exhibited the commitment and capacity necessary to achieve and sustain the compact program's expected results, including actual progress against planned timelines and work plans, the extent to which the compact program remained on track to achieve important process and output targets, and the partner country's commitment of its own resources to ensure the compact's success. Third, the Board of Directors examines the degree to which the partner country implemented its previous compact program in accordance with MCC's standards and policies (including MCC's commitment to the timely, accurate, and transparent reporting of monitoring and evaluation information) and MCC's commitment to directly addressing fraud or corruption concerns, including with respect to abnormalities in procurement processes or with potential misuse of funds.

- ii. **Improved Scorecard Policy Performance:** Beyond successful implementation of the previous compact, the MCC Board expects the country to have improved its overall scorecard policy performance during the partnership, and to pass the scorecard in the year of selection for the subsequent compact. In its consideration, the MCC Board focuses on: the overall scorecard pass/fail rate over time, what this suggests about underlying policy performance, as well as an examination of the underlying reasons; the progress over time on policy areas measured by both hard-hurdle indicators—democratic rights and control of corruption—including an examination of the underlying reasons; and other indicator trajectories as deemed relevant by the Board. Other sources of information are also consulted to look at policy performance over time in areas not covered by the scorecard, but that are deemed important by the Board. For that reason, the Board of Directors will closely examine each partner country’s patterns of actions and indicator trends over time for evidence that these kinds of improvements have taken place.
- iii. **Commitment to Further Sector Reforms:** Finally, the Board of Directors expects that subsequent compacts will endeavor to tackle deeper policy reforms necessary to unlock an identified constraint to growth. Consequently the Board carefully considers the extent to which a country implemented and followed through on any policy, legal, institutional, or regulatory reforms that were necessary to enhance the benefits or ensure the sustainability of its previous compact program. In making decisions about selection to develop a subsequent compact program, the Board of Directors expects a partner country to have implemented such reforms thoroughly and effectively in the past and to demonstrate an ability and willingness to undertake deeper, more fundamental reforms in a subsequent compact program.

Implications for Compact Development Resources

Once selected to develop a subsequent compact, MCC looks for each partner country to build upon its successful working relationship with MCC staff and its understanding of MCC’s model and approach. In particular, MCC expects subsequent compact countries to commit more significant human and financial resources to the compact development process. Such resources include the allocation of an ample budget to cover the costs associated with compact development, as well as the rapid recruitment, selection, and deployment of a national coordinator and a Compact Development Team that has appropriately skilled individuals in each important staff position. Staff from the existing Millennium Challenge Account (MCA) accountable entity team may provide mentoring and advice, participate in brainstorming sessions, offer feedback on discreet documents, and share lessons learned from the implementation of projects that are relevant to the development of a subsequent compact. However, in all other ways, the Compact Development Team must be separate and distinct if the previous compact is still in its implementation or closeout phases.

In addition to budgets and staff resources, MCC expects subsequent compact countries to plan and execute a robust process for consultation and outreach with a wide variety of stakeholders. In particular, the consultative process for a subsequent compact country should place heavy emphasis on seeking input from and developing partnerships with civil society organizations, the private sector, and other international development partners.

At critical stages of the compact development process, subsequent compact countries may also be called upon to conduct a range of economic, technical, social, gender and environmental studies, where doing so will contribute to the quality or pace of the compact development process.

Implications for Content

Each partner country that is selected to develop a subsequent compact program should exhibit an understanding of MCC's model built on the experience, knowledge, and understanding it gained during the development and implementation of its previous compact program. With this advantage, MCC expects subsequent compact countries to be in a better position to develop clear, convincing concepts and strong project proposals that meet MCC's requirements, standards, and expectations. These include MCC's emphasis on integrating robust social and gender analysis into each stage in the compact development process.

In assessing a partner country's concepts and project proposals, MCC has a particular interest in making sure that lessons learned from the implementation of a previous compact program are fully reflected, applied, and incorporated into concepts and project proposals for a subsequent compact program. MCC expects the partner country to include a detailed analysis of actual and expected results, planned versus actual timeline, and other **lessons learned** from the previous compact. MCC also expects the partner country to explain how it will address environmental, social, and other risks; how it will handle critical policy and institutional issues; and how it will control any factors that led to cost increases during the implementation of its previous compact program. As the results of impact evaluations and other assessments of the previous compact program become available, the partner country must use this use data to inform project proposal assessment, project design, and implementation approaches.

MCC expects that subsequent compact programs reflect a clear understanding of the need to ensure that public institutions and public policies support any proposed investments. Toward that end, subsequent compact programs should identify proactively the policy, legal, regulatory, and institutional reforms that are necessary to overcome constraints to economic growth and poverty reduction, and ensure the long-term sustainability of the proposed compact program's objectives, to demonstrate the political will needed to overcome them, and to make clear and measurable commitments to achieve meaningful reforms during the development and implementation of the subsequent compact program.

Finally, MCC expects subsequent compact programs to reflect the potential of partnerships with civil society organizations, the private sector, and other international development organizations to maximize the impact of compact objectives. At a minimum, MCC will look for evidence that each partner country has considered approaches involving the private sector in developing concepts and project proposals for its subsequent compact program. Where such partnerships are feasible, MCC may also have an interest in encouraging a broad range of financing instruments, such as guarantees and other risk-sharing instruments, investment facilities, output-based aid, performance contracting, parallel financing, matching grants, and first loss facilities.

Implications for Funding

MCC has a strong institutional interest in country contributions that will have long-term impact on development results and sustainability of MCC-funded investments. For that reason, MCC expects each country that is selected to develop a subsequent compact program to identify and commit significant financial resources toward achieving the program's objectives. For low-income countries, a partner

country commitment of not less than 7.5 percent of the compact program's total budget is expected. For lower-middle income countries, a partner country contribution of 15 percent is expected. These contributions should be focused on supporting improved performance toward, or sustainability of, compact objectives. MCC will work with each country partner to identify and estimate the value of these contributions, with the goal of maximizing the benefit from available resources without introducing excessive complications.

D. Overview of the Compact Development Process

When an eligible country is selected by the MCC Board of Directors to develop a compact (a *selected country*), it begins the process of conceiving, proposing, and developing a set of proposed investments, interventions, and activities. Over time, that process leads to a coherent compact program that targets the country's most "binding" constraints to economic growth, generates increased income for beneficiaries, and reduces poverty while meeting MCC's other rigorous standards and requirements. Although MCC is available to provide guidance and support, the selected country assumes primary responsibility for the pace, rigor, and ultimate success of its compact development process.

In developing a compact program, selected countries typically follow a process that includes five distinct phases. During the **Preliminary Analysis** phase, the selected country identifies binding constraints to its own sustainable, long-term economic growth and the reduction of poverty and consults the private sector, civil society, potential beneficiaries, and other key stakeholders to gather information and validate findings. In the **Problem Diagnosis** phase, the selected country analyzes the root causes that give rise to the binding constraints and identifies specific core problems around which to organize potential investments and other activities. In the **Project Definition** phase, the selected country begins identifying and defining specific activities and investments that are most likely to address the agreed problems and result in appropriate rates of economic growth and poverty reduction while also meeting MCC's other standards and requirements. In the **Project Development** phase, the selected country fully prepares proposed projects through feasibility studies and other assessments and determines costs, outputs and outcomes, and beneficiaries, subject to a final appraisal by MCC. Finally, during the **Negotiations** phase, the country engages in final discussions with MCC to reach agreement on the specific activities, budget, objective, data collection and reporting, and legal requirements that will comprise the compact program. When a program has been fully agreed, including having been approved by MCC's Board of Directors, the selected country may enter into a compact, a five-year agreement through which MCC provides grant funding to support achievement of the agreed developmental objectives.

These phases, along with the standards and requirements that pertain to each, are described below and discussed in more detail in the chapters that follow.

Phase 1: Preliminary Analysis

An eligible country selected by the MCC Board of Directors to develop a compact begins the Preliminary Analysis phase by appointing an experienced, full-time leader and designating a team of specialists (together, a *Compact Development Team*) to lead the compact development process and work in close collaboration with MCC. The team undertakes a detailed preliminary analysis (an *Integrated Constraints*

Analysis) designed to identify the country's most binding constraints to the growth of the economy and the reduction of poverty.

At the same time, the Compact Development Team begins reaching out and engaging a wide variety of stakeholders across the country's public sector, private sector and business community, nongovernmental and civil society organizations, and academia (through a *Public Consultation and Stakeholder Engagement* process) to understand their perspectives, gather information and data, and validate results from the Compact Development Team's constraints analysis.

The Preliminary Analysis phase ends with agreement between the selected country and MCC on a limited number of binding constraints that will inform the development of a potential compact investment program. For most selected countries, this phase takes about six (6) months from selection, or about four (4) months from early visits by senior officials on MCC's management team and technical staff on the MCC country team.

Phase 2: Problem Diagnosis

During the Problem Diagnosis phase, a selected country undertakes a *Root Cause Analysis*, a structured assessment of the underlying factors, challenges, or problems that give rise to the binding constraints that the selected country has identified. Having diagnosed the root causes, the selected country identifies and chooses one or more as core problems that it expects to address through a compact program, along with the outcomes it expects to achieve by addressing each problem. To facilitate an early exchange of technical information with MCC, the selected country presents this information through one or more detailed *Concept Notes*. Each Concept Note defines a distinct core problem and its link to the binding constraint; describes its impact on poverty and key target populations; clarifies the expected outcomes; outlines a comprehensive approach that will largely resolve the problem; and lays out a theory of change that leads to long-term income growth and poverty reduction. MCC's country team examines the selected country's submission and develops an assessment of the most promising aspects in an *Opportunity Memorandum* for the MCC senior management to consider.

The Problem Diagnosis phase ends with the presentation of the Opportunity Memorandum to MCC's senior management and an understanding between the selected country and MCC of the primary elements of an agreed proposed compact program. For most selected countries, this phase takes about four (4) months to complete.

Phase 3: Project Definition

During the Project Definition phase, a selected country develops a detailed *Project Proposal* for each of the primary elements or projects within the agreed proposed compact program. Each proposal serves to clarify, organize, and prioritize agreed investment ideas and to establish a coherent logic for the proposed compact program. To achieve this goal, each Project Proposal presents specific proposed investments and activities (in most cases, a combination of training, skills development and capacity building; capital investments; institutional strengthening measures; and critical regulatory, legal, and policy reforms); estimates their costs and benefits; identifies specific beneficiary populations and explains how benefits will

accrue to the poor, women, and disadvantaged social groups; and describes in detail the logical cause-and-effect relationships that lead from each of the proposed investments and activities to changes in behaviors and improved outcomes. MCC's country team examines the Project Proposal to assess the level of preparation; the potential economic and social impact; the environmental, social and gender risks; and the sustainability of the proposed projects. At the same time, the MCC country team also explores possibilities to reduce costs, enhance benefits or improve the distribution of benefits towards the poor, as well as ways to increase private investment in relation to the proposed projects. On the basis of its assessment, the MCC country team develops an assessment of the most promising aspects of the Project Proposal (in a *Project Proposal Assessment Memorandum*) for the MCC senior management to consider. The Project Proposal Assessment Memorandum includes the MCC country team's proposed timeline, resources and work plan for fully developing the most promising aspects of the projects to meet MCC's rigorous investment standards during the next phase of the compact development process.

The Project Definition phase ends with the presentation of the Project Proposal Assessment Memorandum to MCC's senior management and an understanding between the selected country and MCC of the specific projects that will be fully developed for investment decisions. For most selected countries, this phase takes about four (4) to five (5) months to complete.

Phase 4: Project Development

During the Project Development phase, each selected country fully develops the plans for the agreed-upon projects. Full development generally involves preparing statements of work or terms of reference; procuring consultants and contractors; and undertaking detailed feasibility studies, environmental and social impact assessments, social inclusion and gender assessments, and preliminary project design studies. Throughout the Project Development phase, the selected country also will work closely with MCC to develop a full understanding of the costs and expected benefits, a clear picture of the expected beneficiaries and projected distribution of benefits across population groups, and a detailed plan for the monitoring and evaluation (M&E) of the progress, outputs, and outcomes associated with each project. These requirements make the Project Development phase the most lengthy and costly part of the compact development process. When a selected country needs assistance with the cost, time, or management of these studies, MCC is often able to provide financial support through a grant of *Compact Preparation Funding*.

As the Project Development phase moves forward, the selected country also begins organizing and structuring the necessary framework for compact implementation. This framework generally includes an agreement on counterpart contributions from national and local governments; a staffing plan and legal structure for the entity that will manage and oversee the implementation of the compact program; operational agreements with public or private entities that will conduct implementation; work plans and other arrangements for the management and execution of projects; and arrangements for procurements and funds control, among many other issues.

During this time, MCC will assess the proposed project(s) and the proposed framework for implementation. As the appraisal moves forward, MCC may advise the selected country that modifications in project scope, approach, or design are needed in order to improve focus, maximize

impact, improve quality, enhance implementation, lower costs, or increase benefits. Such exchanges of views and technical modifications are critical to the Project Development phase. At the end of the process, the MCC country team develops an *Investment Memorandum* for MCC senior management to consider. The Investment Memorandum includes the team's final assessment of the objectives, scope, costs, benefits and risks associated with each agreed project and with the proposed compact program overall.

The Project Development phase ends with the presentation of the Investment Memorandum to MCC's senior management. For most selected countries, this phase takes twelve (12) to sixteen (16) months to complete.

Phase 5: Negotiation

During the Negotiation phase, MCC prepares a draft compact and other legal documents for discussion with to the selected country. When agreement on the specific activities, budget, objectives, data collection, and reporting and legal requirements has been reached, MCC submits the agreed compact to its Board of Directors for consideration. Only after approval from the MCC Board of Directors and a non-objection from the United States Congress can MCC and the selected country sign and implement their compact agreement. At that time, MCC commits funding for the entire five-year compact program.

The Negotiation phase ends with the signing of the compact documents. For most selected countries, this phase takes roughly one (1) to two (2) months from the end of the Project Development phase.

Timeline for Compact Development

Each selected country should expect the process of developing a successful compact program to take more than two years but less than three years, if aggressively managed. A variety of factors can impact that general timeline, sometimes quite significantly. Such factors include the speed with which the selected country staffs its Compact Development Team; the degree of authority and autonomy granted the Compact Development Team; the depth and range of skills on the Compact Development Team; the depth of coordination between the selected country's government, its civil society and private sector, and its other development partners; the level of preparation of the specific investments, activities, and interventions proposed; the focus and coherence of the overall compact program; and the quality of engagement, oversight, and leadership from the selected country's senior leaders.

A note on Public Consultation and Stakeholder Engagement

MCC believes that meaningful, ongoing engagement with stakeholders is a key to the development and implementation of a successful compact program. Effective stakeholder engagement offers selected countries an opportunity to engage important individuals and organizations as partners in compact development; to obtain expert advice and collect qualitative data for technical analyses; to ensure that decisions about the direction and content of the proposed compact program are well informed; to validate or adjust analyses, thereby helping ensure the technical quality of work; to manage risks and impacts; and to identify opportunities to maximize development impact. When done well, stakeholder engagement also helps ensure the long-term sustainability of the compact program's impacts.

Early analysis and planning is important for staffing, scoping, and properly integrating stakeholder engagement into the compact development process. When carried out, stakeholder engagement will encompass a wide range of approaches, each of which may be used at different stages in the compact development process. These include:

- *Public outreach, generally a one-way disclosure and dissemination of information from the Compact Development Team to stakeholders.*
- *Consultation, a two-way dialog between the Compact Development Team and stakeholders.*
- *Qualitative research for technical studies, such as input through interviews or focus groups. During compact development, this approach is often lead by economists, gender and social inclusion experts, and others.*
- *Participation in decision making.*
- *Grievance redress, a process by which grievances can be raised and resolved.*
- *External / ongoing reporting to stakeholders.*

Chapter 1: Establishing a Compact Development Team

Eligible countries selected by the MCC Board of Directors to develop a compact bear primary responsibility for the success of the compact development process. To ensure a strong start, each selected country should convene a capable, professional team to handle the day-to-day work requirements, manage the overall compact development process, and coordinate and collaborate directly with MCC. This team, known as the Compact Development Team, will include an experienced, full-time national coordinator supported by a staff of well-qualified subject matter experts and technical specialists.

Each selected country should begin taking steps to structure, resource, and staff its Compact Development Team as quickly as possible after selection. This is a critical step for a selected country, as it directly impacts the depth, pace, and quality of work throughout the compact development process.

Institutional arrangements

Among its earliest decisions, each selected country must determine the office, agency, department, or ministry that will house its Compact Development Team and spearhead its compact development process. Inherent in this decision is a determination about a *political point of contact* – generally a minister or senior civil servant – who will secure necessary resources for the Compact Development Team, provide a conduit of information to other senior officials, oversee the development of the compact program, and engage in high level communications with MCC.

Institutional arrangements for the Compact Development Team should reinforce the country's commitment to compact development and facilitate the work of the team. At a minimum, the arrangements should serve to reduce bureaucratic obstacles, expedite decisions, augment flexibility and creativity, facilitate the team's access to senior leaders, and strengthen its ability to obtain data and information, documentation, expertise, and human resources from a wide range of government ministries, departments, and agencies, as well as from the country's civil society and private sector organizations. Although there is no standard approach, many selected countries have found that the Compact Development Team is most effective when housed within the office of the country's president or prime minister. Others have found a ministry of finance, economic planning, or economic development that plays a powerful coordinating role within the government also works well.

Beyond the political point of contact, many countries have found it useful to create a high level *steering committee* to generate broad participation and ownership over the compact development process. Such steering committees are generally chaired by the political point of contact and include other senior officials from relevant ministries, along with representatives from civil society organizations and the private business community. In such cases, the steering committee sets the overall direction of the country's compact development process; reviews and approves reports, proposals, and other formal documents; takes decisions at critical junctures; and resolves difficult issues. Selected countries may wish to change the composition of such steering committees over time as the compact program becomes more defined.

Administrative and financial resources

The Compact Development Team will need significant administrative and financial resources to manage the compact development process effectively. Among other resources, the Compact Development Team will need a working space, whether within a government office building or in commercial office space, that is large enough for its staff and appropriate for regular meetings with stakeholders, advisors, and visiting MCC teams. This working space should be equipped with international phone and e-mail services that allow for frequent exchange of data, information, and documents. The Compact Development Team also will need access to standard office supplies and office equipment, and may benefit from support staff, transportation, and other services as well.

Each selected country must provide its own *budget* to cover these and other costs associated with the Compact Development Team. Total costs vary among selected countries but generally range from a low of \$0.5 million to a high of \$3.0 million. MCC encourages selected countries to identify and dedicate budget funds for its Compact Development Team as quickly as possible after selection in order to avoid delays in hiring staff and starting the compact development process in earnest. For certain selected countries that face a particularly tight budget environment, MCC may be able to offset a portion of these costs through a grant of Compact Development Funding for Initial Engagement (see Chapter 2).

Staffing

The Compact Development Team will undertake detailed analysis and assessment of critical economic and social issues, solicit and integrate input from a broad range of stakeholders, and identify and justify critical areas for potential investment using MCC funding. MCC expects each selected country to fill the following positions as part of its Compact Development Team, generally within two (2) months of selection. In filling these positions, a selected country may select national or international candidates and may hire or procure staff on a part-time or full-time basis, as needed to secure the best talent while also meeting standards and completing work. The Compact Development Team will expand during subsequent phases of the compact development process (see Chapter 5), and its composition may change as the compact development process progresses.

National Coordinator: Given the complexity of compact development, each selected country benefits from having one “national coordinator” who bears responsibility for organizing and executing the compact development process. The national coordinator will lead the recruitment and hiring of the Compact Development Team and will manage the team’s detailed daily work throughout the compact development process. The national coordinator also will engage key stakeholders across the government, the business community, and civil society organizations; share relevant information with the political point of contact, the steering committee, and other senior officials; and bear responsibility for the overall quality of the Compact Development Team’s work, including official submissions to MCC.

Successful candidates for the national coordinator position tend to have extensive experience working at the highest levels of government or the private sector; a high degree of comfort with the management of large, complex, interdisciplinary projects or processes; knowledge of economic development issues or prior work with international development organizations; and some exposure to the discipline of project

management.

MCC asks each selected country to make its national coordinator available on a full time basis. To increase efficacy, each selected country should grant its national coordinator authorities to access and expend the compact development budget; to recruit, hire, and manage all necessary staff; to manage cooperation across the government; to coordinate with civil society, the private sector, and international development partners; to conduct public outreach; and to make critical decisions throughout the compact development process. Each selected country should also take steps to ensure that its National Coordinator enjoys strong political support, has access to senior officials and decision makers, and can readily obtain data and information, staff time, and other necessary resources from all relevant government entities.

Economist: Each Compact Development Team should include at least one senior economist who will take the lead in identifying, assessing, and explaining the underlying economic logic and likely economic impact of the selected country's proposed compact program. In the preliminary stage of compact development, the economist will organize and lead the selected country's research and assessment of the Constraints to Economic Growth Analysis (see Chapter 3). In later stages, the economist will build the economic justification for concept projects, develop a detailed program logic, conduct a detailed analysis of the economic characteristics of any proposed projects, calculate economic rates of return (ERRs) for proposed projects, and assess how proposed projects will impact intended beneficiaries through a Beneficiary Analysis, with particular attention on poor households and disadvantaged groups, including women. In many cases, the economist also will manage inputs from support staff, external consultants, and partner institutions, and will ensure communication about costs and benefits of the proposed program with external stakeholders.

Strong candidates for the economist position will have an advanced degree in economics, finance, or public administration and a number of years of experience in project economics, including prior work with a national economic development agency or international development partner.

Private sector development specialist. The Compact Development Team also should include a private sector development specialist who will identify and assess impediments to private business activity and will develop opportunities to expand private sector participation and private sector investment through the selected country's proposed compact program. In the preliminary stage of compact development, the private sector development specialist will work closely with the economist to ensure a full understanding of private business concerns that arise in the analysis of constraints to economic growth. In later stages, the private sector development specialist will identify and develop approaches that address those concerns or otherwise ensure the long-term financial and institutional sustainability of the selected country's proposed compact program. In many cases, the private sector development specialist also will manage outreach to the business community, including small and medium business owners, industry leaders, business associations, and domestic and foreign investors.

Strong candidates for this private sector development position will have an advanced degree in economics, finance, business or business administration, or a related field, along with a number of years of experience in economic planning, economic development, investment promotion, trade promotion, or another field that involves private sector concerns.

Social inclusion and gender integration specialist: The Compact Development Team staff also should include a social inclusion and gender integration specialist. This specialist ensures that the proposed compact program addresses social and gender inequalities that can limit economic growth and the reduction of poverty and is primarily concerned with gender equality, poverty reduction and inclusive growth. The social inclusion and gender integration specialist works to ensure that the proposed compact program is developed in such a way that anticipated benefits reach the poor and include women and other disadvantaged groups. In the preliminary stage of compact development, the social inclusion and gender integration specialist will work closely with the economist to ensure a full understanding of the legal, institutional, social, and cultural issues that impede economic growth and poverty reduction among women, the poor and disadvantaged social groups, as part of the analysis of constraints to economic growth, the problem diagnosis, and project definition. In later stages, the social inclusion and gender integration specialist will participate in the development and design of proposed projects to ensure that social inclusion and gender issues are fully addressed. The social inclusion and gender integration specialist will help design of the public consultation and stakeholder engagement strategy to ensure full participation of groups representing women and disadvantaged populations.

Strong candidates for this social inclusion and gender integration position will have a detailed understanding of the extent and nature of poverty and social inequality in the country, and a strong knowledge of policies, laws and institutions that relate to social inclusion and gender equality concerns in the selected country. Most candidates will have an advanced degree in sociology, anthropology or a related social science field, along with extensive work experience related to poverty, social inequality, and gender issues, including work with an international development partner.

Public outreach and stakeholder engagement specialist: The Compact Development Team should include a public outreach and stakeholder engagement specialist to solicit public comment, incorporate meaningful input from key stakeholders into the selection, development, and design of projects, and ensure transparency throughout the compact development process. The public outreach and stakeholder engagement specialist will plan and execute a broad process of public consultations and stakeholder engagement during the early stages of compact development, working in close collaboration with the Compact Development Team private sector specialist and gender and social integration specialist, and will ensure continued engagement with stakeholders throughout the compact development process.

Strong candidates for the public outreach and stakeholder engagement position will have a degree in public policy, community development, communications, public relations or a related field. Their prior work should include experience leading public information campaigns or organizing and conducting participatory stakeholder consultations, including work with international development partners.

Chapter 2: Compact Development Funding for Initial Engagement

Following selection, countries enter a rigorous compact development process that requires considerable resources. The availability of funding is a critical element in each selected country's ability to start the process quickly and to sustain a successful engagement with MCC. MCC recognizes that selected countries have limited resources and face a range of limitations, inhibiting their ability to identify, mobilize, and commit financial resources as soon after selection as needed.

By law, MCC has limited authority to extend financial support to selected countries at key steps in the compact development process. This financial support is known as *Compact Development Funding* and is provided in the form of a grant. MCC may utilize its authority once a country is selected by its Board of Directors to develop a compact to support the country in taking certain discrete actions that are critical to a rapid start-up and a successful initial engagement with MCC. This funding is intended to supplement – not replace – the budget that each selected country provides for compact development.

Purposes of Compact Development Funding for Initial Engagement

MCC provides Compact Development Funding to help with the recruitment, selection, hiring, and retention of the Compact Development Team, and each selected country may use Compact Development Funding to cover costs associated with salaries and related benefits, such as pensions, health coverage, disability pay, holidays and leave. During the first several months of the compact development process, a selected country may use this funding to support its National Coordinator and other staff members needed in the Preliminary Analysis phase (as described in Chapter 1). In later phases, the selected country may apply Compact Development Funding to support additional technical specialists needed for the preparation of detailed Concept Notes and Project Proposals. The selection, appointment, or hiring of staff members, their salaries, and the execution of their employment contracts may be subject to MCC's approval if funded with MCC's Compact Development Funding.

In certain cases, Compact Development Funding also may cover fees associated with the use of external consultants on a short-term basis. Such consultants may, for instance, provide support during the development of an Integrated Constraints Analysis, a public outreach and stakeholder engagement approach, or the root cause analysis. In such cases, the procurement process and the consulting contract may be subject to MCC's approval, as well.

Implementing Compact Development Funding for Initial Engagement

MCC will work with the selected country to finalize and execute a legal agreement for the use of Compact Development Funding for initial engagement quickly, generally within two (2) months following selection. The legal agreement will include a detailed description of the agreed use of funds and a detailed budget.

The legal agreement also will clarify limitations, outline requirements, and specify the documentation and approvals process required for the release of any agreed funds.

To facilitate the process of finalizing terms of this agreement and the use of the funds, MCC asks that each selected country clearly identify and authorize a senior official within the relevant government ministry, agency or department as soon as possible. Such an official will generally sit within the ministry, agency or department responsible for finance, international affairs, economic development or planning. In addition, each selected country will need to identify and authorize legal counsel to review, negotiate, and finalize the language and legal terms of this agreement.

MCC will work with each selected country to establish proper accountability, oversight, and control for the use of Compact Development Funding. As a general rule, MCC will cover the payment of salaries and other authorized expenses on a reimbursable basis.

Once a reimbursement basis is established, MCC will work with the selected country to understand the country payment process/system in order to establish clear procedures and internal controls around the reimbursement process. MCC will aim to clearly delineate the roles and responsibilities of the selected country in presenting a control framework that MCC deems reliable.

Country Commitment of Funding

MCC offers Compact Development Funding for initial engagement to ensure that each selected country has access to the financial resources it needs to start up and staff its Compact Development Team. As such, MCC can only make Compact Development Funding for initial engagement available until the selected country's submission of Concept Notes and Project Proposals. Compact Development Funding is not intended to cover all of a selected country's costs and is not a substitute for the commitment of significant country resources to the compact development process. Such funding may be subject to additional conditions, at MCC's discretion.

Selected countries remain responsible for providing their Compact Development Teams with a wide range of services and support (as discussed in Chapter 1). Each selected country should expect to make appropriate office space available to its Compact Development Team, to provision its Compact Development Team with office supplies and office equipment and to support the work of its Compact Development Team with support staff, as may be necessary and customary. Where the Compact Development Team may need access to vehicles or may need to engage in domestic travel, the selected country should also expect to cover the associated costs.

Chapter 3: Guidelines for the Constraints to Economic Growth Analysis

Each selected country begins the compact development process with a thorough analysis of its economy aimed at identifying the most serious impediments to economic growth through their impact on private investment and entrepreneurship. This analysis includes the use of a series of diagnostic tests to identify which of several economy-wide constraints are most binding to private investment and entrepreneurship within a specific country's context. This overarching analysis is further refined and contextualized through a targeted analysis of those constraints at the industry- or firm-level; and a thorough consideration of key social dynamics that could affect patterns of growth and poverty reduction, with a particular emphasis on the ability of disadvantaged groups to benefit from growth. This analysis, taken as a whole, is known as the constraints analysis at MCC. It forms a major component of the Preliminary Analysis phase.

The constraints analysis is designed to provide each selected country with a clear central focus as it moves into later stages of the compact development process. The methodology that grounds this analysis provides a structured approach to economic analysis at the country-level that reflects the objective of facilitating private investment in economic activity in a manner that reduces poverty. Through a series of rigorous economic tests and analyses as well as cross-country comparisons, the methodology helps identify the “binding constraints” that most severely inhibit private investment and restrict the potential for long-term economic growth.

MCC's constraints analysis methodology further recognizes that the analytical process will produce robust findings only to the extent that it incorporates a wide variety of inputs. Thus, the MCC constraints analysis methodology incorporates additional data and information that reflect specific concerns about (i) social and gender inequalities that may characterize the economy or shape policies and institutions, thus affecting opportunities to raise incomes or alleviate poverty, and (ii) business and industrial performance issues that may influence contributions to job creation, private business activity and economic growth. Including these perspectives helps ensure that any conclusions about binding constraints are based on a complete understanding of the country's economy and the potential impact of economic growth on poverty.

At this early stage in the compact development process, the use of the decision tree below and its diagnostic questions helps a selected country maintain its focus on identifying, defining and analyzing problems, rather than leaping to possible solutions. It is not the job of the constraints analysis report to identify potential projects that would promote growth or reduce poverty. That said, it is relevant to include discussion and investigation of barriers to poverty reduction, access to growth or discriminatory policies and institutions where they arise in context of the constraints, as well as to note where constraints may affect certain sectors, industries, regions, or social groups more severely.

This guidance document provides a brief description of the constraints analysis methodology, the inclusion of data and information that reflect specific social, gender and industry concerns, the identification of binding constraints, and the drafting of a final report, known as a constraints analysis report. These steps constitute the starting point for selected countries that seek to develop a compact for

MCC assistance. MCC will provide each selected country a more detailed technical discussion of this methodology and its application. This chapter serves as a resource and guide for each selected country as it works to produce a constraints analysis that provides the analytic foundation for compact or threshold program development. After the constraints analysis is complete, each selected country will undertake a more comprehensive assessment of some or all of the binding constraints that the constraints analysis has identified and will ultimately design a compact or threshold program that includes a range of investments and other activities, including policy, legal, regulatory and institutional reforms tailored to address the binding constraints.

Overview

MCC is founded on the principle that private sector-led economic growth is critical for achieving sustainable development that raises standards of living and improves human development. The constraints analysis builds on the premise that private investment – whether by individuals or firms, whether domestic or foreign – represents the primary engine for long-term, sustainable economic growth. Countries seeking to accelerate economic growth are faced with the fundamental question, “What constrains private investment and entrepreneurship?” The purpose of the constraints analysis is to identify the key problems that constrain private investment by firms and individuals and thus limit opportunities for economic growth and poverty reduction.

The constraints analysis is based on a framework proposed in the seminal paper, “Growth Diagnostics,” by economists Ricardo Hausman, Dani Rodrik and Andres Velasco. Noting that the challenges of economic growth differ from one country to the next, they present an analytical framework that identifies the range of issues that constrain economic growth and helps prioritize among them. This framework allows policy makers, planners and development professionals to focus the limited political capital, institutional capacity and financial resources they command toward lifting or relaxing the most severe constraints, thereby generating higher levels of economic growth. While the framework is often referred to as a “growth diagnostic,” MCC generally describes it as a “constraints analysis” model or methodology.

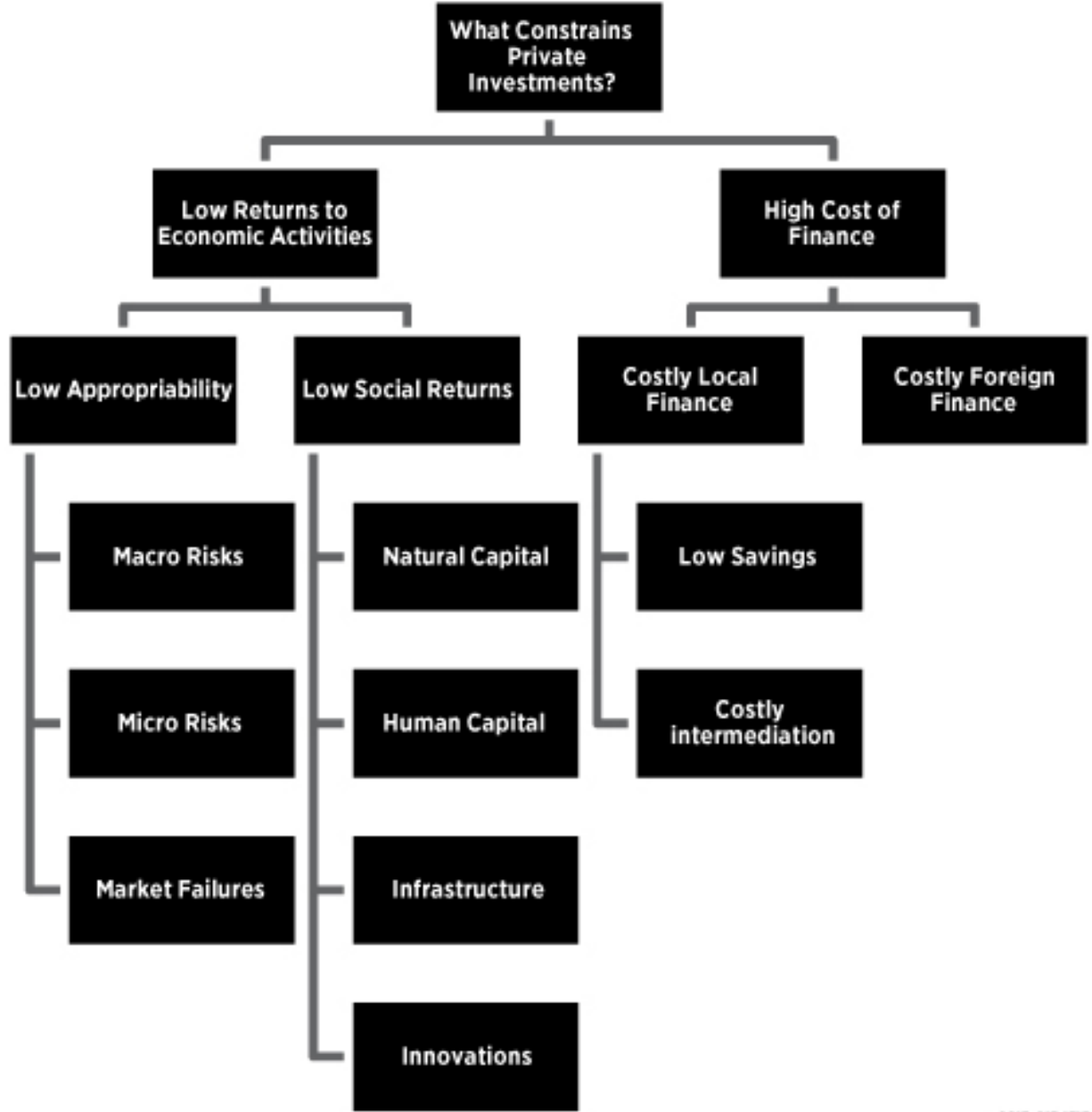
Briefly, the framework recommends starting with a general review and analysis of the specific country context and growth history in order to understand the “growth story” of a country and provide context for understanding the constraints. The framework then argues that the incentives an individual or firm faces when considering an investment fall into three broad categories, which make up the main branches of a decision tree (see Figure 1):

1. The social (overall) expected return on an investment, which is generally dependent on complementary factors of production such as infrastructure or human capital.
2. The risks an investor faces and the resulting share of the return the investor can expect to keep. This is known as appropriability and is reduced by things like high taxation, crime, and macroeconomic instability.
3. The cost and availability of financing the investment. Even when an investor has good projects with low risk, he or she still may not be able to invest without access to finance.

The constraints analysis methodology then involves a series of diagnostic questions that are designed to test and highlight underlying issues that may constrain private investment in any country context. Using

the decision tree as a guide, the methodology encourages systematic examination of each branch of the tree under these three broader categories to identify possible explanations for low levels of private investment and, in turn, low rates of economic growth rates. As an example, if evidence shows that the cost of capital is out of line with international norms, do the distortions stem from domestic financial markets or from external financial markets? Or, if evidence suggests that the returns to private economic activity are a concern, do the underlying issues stem from inadequate appropriability – that is, the opportunity for investors to fully capture or appropriate those returns – perhaps due to macroeconomic instability, “micro” risks like corruption, high taxation, weak property rights, discriminatory policies or institutions or failures in markets? Or, do the underlying issues stem from low social returns to investment, due to a lack of competitiveness or the insufficient supply of complementary factors of production, such as infrastructure or human capital?

Figure 1



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Aligned with MCC's data-driven focus, the constraints analysis aims to produce robust findings by incorporating a wide variety of data from an extensive pool of reliable sources. Using the decision tree, the selected country should strive to explore and identify the fundamental causes and issues that limit private investment and economic growth, rather than merely highlight the symptoms. As an example, the background analysis of the growth history of a country may highlight the importance of agriculture to GDP and historical income gains. The country may then present evidence that low agricultural productivity acts as a constraint to private investment and economic growth. Assessments of the agricultural sector often point to the lack of sufficient irrigation as the problem. While irrigation may be an issue, the constraints analysis methodology should push a selected country to look for underlying causes of inadequate irrigation, which might include low levels of human capital concerning cropping practices, poorly-defined or highly unequal property rights that limit investment in the land, or high levels of soil erosion. In this context, a focus on irrigation infrastructure alone might actually exacerbate underlying issues if they relate to poor management of ecosystem services provided by forests and watersheds. The use of investigation to dig deeper into face-value causes of problems is critical to conducting a good diagnostic.

At each branch, the constraints analysis should consider the industry- or firm- specific manifestations of each potential constraint. Firm-level evidence can provide a more detailed understanding of potential constraints by highlighting their impact on the decision-making and behavior of private agents throughout the economy. For example, aggregate indicators might point to a shortage of skilled workers as a constraint, but only additional analysis would identify specific types of skilled workers needed (such as electricians or project managers).

Table 1 provides some examples of how an industry-level lens (rows) can help contextualize economy-wide constraints (columns). Teams can use this lens to better understand how constraints identified by the diagnostic tests are experienced and constrain specific industries.

Industry	Constraint									
	High Cost of Finance	Low Returns to Economic Activity								
		Low Social Returns						Low Appropriability		
		Natural Capital	Human Capital	Physical Capital (Infrastructure)			Innovation	Market Failures	Macro Risks	Micro Risks
Energy	Transport			Water / Sanitation						
Light Mfg			Mechanics	Costly	Costly					Reg. Red tape
Agricult.			Agro nom	Ltd acc	Costly			Value		

Industry	Constraint									
	High Cost of Finance	Low Returns to Economic Activity								
		Low Social Returns						Low Appropriability		
		Natural Capital	Human Capital	Physical Capital (Infrastructure)			Innovation	Market Failures	Macro Risks	Micro Risks
Energy	Transport			Water / Sanitation						
			High	Essential				Chain gaps		
IT			IT Specific	Costly						
Tourism			Hospitality							
Etc.										

Throughout the constraints analysis, a selected country should consider the social and gender aspects of the diagnostic questions and the available evidence. Such information generally leads to a more complete understanding of the context in which private investment and economic activity occurs. It may thus inform and strengthen insights related to economic constraints. As an example, low agricultural productivity may have social and gender dimensions with significant implications for efforts to improve agricultural earnings or reduce rural poverty. This may be the case where women farmers perform a high proportion of certain kinds of labor in the agricultural value chain but where social norms, policies and institutions systematically provide them lower levels of access to inputs, credit, and training. A strong constraints analysis methodology will consider such issues in its examination of underlying causes. Because the distribution of income gains from economic growth is important to MCC, the constraints analysis report should note whether particular constraints affect some groups more strongly than others.

Ultimately, the constraints analysis methodology seeks to arrive at a well-developed understanding of the country's experience with growth and poverty reduction, including economic sectors that have been or could be drivers of growth or poverty reduction; the constraints to growth in a logical way that accounts for the country's specific growth context; and the potential for future growth and poverty reduction if the identified constraints were relaxed. While the methodology is not intended to produce an exhaustive list of all possible economic concerns, it may lead to the preliminary identification of a number of issues or concerns. Further analysis may be necessary to discern which have a greater impact or are of greater

concern than others and to determine which constitute binding constraints to private investment and economic growth. To help focus the next phases of compact development work, the final constraints analysis report should identify a fairly small number of the most binding constraints. Binding constraints are those that, if relieved, would produce the largest gains in growth and entrepreneurship of any potential constraint areas. Not all areas can be binding. In MCC's experience, the most common number of identified constraints in past constraints analyses has been three (3), and the average number of constraints has been 3.5. If the selected country identifies more, it will bear a substantial burden of proof to demonstrate that all constraints identified are truly "binding" in order to secure MCC's agreement on the results.

Staffing and Conducting the Constraints Analysis

Using the constraints analysis methodology, MCC expects selected countries to identify the binding constraints to private investment and economic growth within roughly six months of being selected to develop a compact or threshold program (and generally within four months of setting up their local teams and starting the process in earnest). Furthermore, MCC expects that the selected country's Compact Development Team will take the lead role in the design, planning and application of analyses and diagnostic tests that inform the results of the constraints analysis. MCC's country team is available to provide guidance and support, advise the Compact Development Team on best practices for the execution of analyses and interpretation of data, and provide oversight of the process to ensure that it conforms with MCC's internal standards of rigor and validity. The entire process involves several steps, as described in more detail below.

Assembling a Constraints Analysis Team: Each selected country is responsible for assembling a team of experts and analysts who will bear the primary responsibility for gathering data and information, analyzing and testing the data and information, determining the country's binding constraints to private investment and economic growth, and drafting the final constraints analysis report. Generally speaking, the selected country's National Coordinator will identify and appoint team members as quickly as possible (generally within two months after selection) and will supervise the constraints analysis process. The other team members should include:

- *Economist: (also discussed in Chapter 1)* a senior economist who will lead the constraints analysis process, manage the day-to-day work and monitor the analytical work of the constraints analysis team, as well -as serve as the primary editor and author of the constraints analysis report. The economist will be the primary analyst responsible for designing and conducting the tests related to the identification of constraints, seeking alternative hypotheses, explaining conflicting data, and ensuring that the overall narrative of the analysis is logical, sound, and rests on as wide a body of reliable evidence as possible. The economist is expected to work closely with the social and gender specialist and private sector specialist to adequately incorporate relevant data and other information to deepen the analysis of important sectoral and social dynamics associated with each constraint.
- *Social inclusion and gender integration specialist: (also discussed in Chapter 1)* a senior sociologist or social scientist with experience in gender and poverty analysis who will assist in the collection and analysis of data disaggregated by social and gender groups, and policy and institutional analysis, and manage, in coordination with other members of the analytical team, consultations

with representatives of different social groups. The role of the social inclusion and gender integration specialist during this process is to provide inputs into the constraints analysis that articulate and describe the differential impacts of constraints across relevant social groups and how poverty and inclusion are affected by each constraint.

- *Private sector development specialist: (also discussed in Chapter 1)* an experienced business policy or business development professional who will assist in the collection and analysis of business and industry data and manage, in coordination with other members of the analytical team, consultations with representatives of business and industry groups. The role of the private sector development specialist in this process is to provide input to the constraints analysis that identifies key economic sectors that could potentially drive future growth and poverty reduction and describes and articulates how development of these sectors may be hindered by the presence of the constraints.
- *Analytical team:* a small team of technically skilled economists, sociologists, political scientists or other analysts drawn from relevant government ministries (such as a ministry of finance, ministry of planning, central bank or national statistics office), from research organizations, think tanks or academic institutions, or from business organizations or the private sector and who have skills and experience gathering, cleaning and analyzing data and/or conducting rigorous qualitative analyses. Analytical team members may be appointed or hired on short-term contracts, based on availability and need.

MCC encourages selected countries to staff their constraints analysis teams with individuals who possess the strong technical background, knowledge, and skills to conduct this kind of data-driven analysis.

In order to broaden the set of experts that are able to provide guidance and insight into the analysis, the selected country may consider establishing a steering committee for the constraints analysis process. A committee of local experts from relevant ministries, academia, the central bank, and other organizations can provide a forum for progress checks, input, feedback, and eventually sign-off on the constraints analysis. The steering committee is not obligatory, but the selected country should consider how best to ensure accountability and build broad country ownership of the results.

MCC's experience has been that the constraints analysis process works best when it is led by a team of country nationals with relevant experience and expertise who can devote full-time resources to their tasks. Though it is not recommended, nor is it MCC's experience that it improves – on average – the quality of the analysis, a selected country may also draw upon international resources throughout the constraints analysis process, as may be appropriate. If selected countries choose to take this route, they should consider how to build “ownership” of an analysis that may be seen as being produced by outsiders.

Planning: MCC will send an economist, a gender and social inclusion specialist, and private sector development specialist, along with other members of its country team, to discuss the details of the constraints analysis methodology and the process for undertaking a complete constraints analysis assessment as soon as possible after a selected country identifies and appoints its National Coordinator and economist. To ensure thorough, timely implementation of the assessment, the selected country should also appoint the other members of its constraints analysis team as soon as possible. Together, MCC and the constraints analysis team will discuss and agree on a comprehensive work plan that includes the specific questions to be addressed, the relevance and applicability of any existing analyses of constraints to growth and poverty reduction, additional key sources of data and information to be

consulted, and a sequence of steps and an overall timeline for the entire process. The teams should also agree on a plan for consultations as the process unfolds.

Data collection: During its initial technical visit, MCC will provide the constraints analysis team with all relevant data and information that is available to MCC, in an effort to facilitate the start of initial analysis. MCC may also provide brief issues papers that review available research on social and gender issues or business and industry issues.

Following the initial technical visit, the constraints analysis team may need to review that data and information in order to determine if any critical pieces are missing and if the available data is sufficiently robust. The constraints analysis team may also need to identify, request, collect and review a substantial amount of additional data and information from sources that do not make their data publically available, including government agencies and external entities.

The constraints analysis methodology requires information from many sources. To expedite the process and avoid duplication of efforts, the constraints analysis team should make maximum use of readily-available data sources and any relevant analyses of constraints to growth that exist. Gender, socio-economic, sector- or industry-disaggregated data should be used to inform or nuance information about constraints. Quantitative data can also be supplemented with qualitative evidence from consultations with relevant stakeholders, as discussed below.

The data needs of a constraints analysis are significant and should therefore be the main priority of the constraints analysis team from the beginning of the process. The constraints analysis team should begin data collection by determining the available data, reports, and other information relevant to the analysis. Additional data needs and sources are likely to arise as the analysis progresses. Likely sources include, but are not limited to:

- Existing constraints analyses, if any;
- Economic reports from government agencies, international financial institutions, or studies by bilateral donors, think tanks, academic organizations, non-governmental organizations and the like;
- National and global surveys, including household and labor market surveys and studies of the domestic business climate, such as the Doing Business Indicators, Demographic and Health Surveys, and the Global Competitiveness Report;
- National and sector strategies; and
- National poverty/social and gender policies, strategies, and indices.

MCC can provide a **Technical Annex** to this guidance document that includes a list of commonly used sources for data and information for further consideration.

Analyzing and testing data: In working through the constraints analysis methodology, the constraints analysis team should subject the data and information it has on hand to four questions or tests that are designed to identify the most binding constraints to economic growth. These tests are:

1. The (shadow) price of the constraint should be high *A relatively high price is indicative of high*

demand.

2. Movements in the constraint should produce significant movements in the objective function *Increasing supply of a potential constraint and observing an increase in a related outcome variable is indicative of pent up demand.*
3. Agents in the economy should be attempting to overcome or bypass the constraint *If supply is limited, but demand is high then economic actors will attempt to find alternative ways to access the factor.*
4. Agents less intensive in the constraint should be more likely to survive and thrive and *vice versa.*

Hausmann, Klinger, and Wagner (2008) also provide further discussion and examples in their Mindbook that apply these principles of differential diagnosis in the context of the constraints analysis methodology.

Broadly speaking, the constraints analysis methodology requires information on levels and trends with respect to a variety of variables and parameters, on both the microeconomic and macroeconomic levels, as well as qualitative evidence indicating the presence of constraints. Wherever possible, the constraints analysis team should provide evidence and data from diverse sources that reflect any systemic bottlenecks to investment. To expedite the process and avoid duplication of efforts, the team should make maximum use of readily available data sources and any relevant analyses of constraints to growth that exist. Wherever gender-, sector- or industry-disaggregated data are available, they should be used to inform or nuance information about constraints. Quantitative data can also be supplemented with qualitative evidence from consultations with relevant stakeholders.

The constraints analysis methodology also requires comparisons between similar countries. To the extent possible, the constraints analysis team should benchmark the performance of the selected country on the same variables and parameters against a set of comparator countries that are carefully chosen based on their similarities in regional location, size and economic structure, resource endowments, similarity of production or export baskets, level of economic development and/or reform history. Such comparison helps the selected country more clearly identify areas ways in which it may lag, and the comparisons may suggest improvements that the selected country can reasonably achieve or identify levels of economic performance to which the selected country can reasonably aspire. Using the average values of a large subset of countries (say low income Asian countries) can help ensure that conclusions reached in the constraints analysis are not overly dependent on the choice of a few, specific comparator countries.

When considering any element of the decision tree, the analyst is faced with the question: “If this is a binding constraint to growth, what effects might I be able to observe in the economy?” To answer these diagnostic questions, selected countries must: (1) select and formulate specific diagnostic questions in a sensible way that reflects their unique country context; (2) research and marshal data and other information that shed light on the questions; and (3) answer the questions in a systematic manner, given the balance of available evidence. In the process, the constraints analysis team should identify, consider and incorporate appropriate data and information related to social and gender inequalities and key industries, along with their implications for growth and poverty reduction. MCC’s country team is available to provide advice and assistance with the design and execution of the constraints analysis where necessary to ensure that results are defensible and sound.

Determining binding constraints is not, as noted above, necessarily a simple or straightforward task. Since

most countries are characterized by scarce resources and less than optimal policy environments, there are typically many factors that constrain private investment and growth. Such an analysis requires knowledge specific to the economy, careful analysis of available data and creative application of diagnostic tests, benchmarking with comparator countries, and careful vetting with stakeholders. To achieve this goal, the constraints analysis must be conducted using reliable information and data and must incorporate, where feasible and appropriate, social and sectoral analysis that deepens the analytical understanding of how constraints affect growth and poverty reduction. A good constraints analysis will incorporate microeconomic, macroeconomic and sector-specific data to determine binding constraints. The constraints analysis report considers additional information that reflects specific concerns about: (i) social and gender inequalities that may characterize the economy or shape policies and institutions, and (ii) business issues that may influence contributions to private business activity and economic growth. Including these perspectives helps ensure that any conclusions about binding constraints are based on a complete understanding of the country's economy, its growth, and how the benefits of that growth are shared.

Where relevant, social and gender and sector-level and industry-level analysis should inform the results of the tests. In order to conserve resources and focus on what is most important to the analysis, the constraints analysis team should take a preliminary examination of all branches of the diagnostic tree to eliminate some areas from further consideration, i.e., those areas that are unlikely to rise to the level of a binding constraint. The constraints analysis team should then focus their analytical effort on those nodes of the diagnostic tree that are more likely to emerge as binding constraints to growth once further analysis is done. These are the constraint areas that will require the greatest analytical rigor and consideration in order to rank constraints and identify those that are most binding. When the constraints analysis team reaches preliminary conclusions about binding constraints to economic growth, it should discuss the results with the MCC country team. Ultimately, the constraints analysis team and MCC must reach agreement before progressing into the last stage of consultations, finalizing the constraints analysis report, and moving on to the next phase of the compact development process.

Consultations: The constraints analysis team should undertake consultations with experts and other stakeholders at various stages of the constraints analysis process. During MCC's initial technical visit, the MCC and selected country teams should consult with ministries, executive departments or other entities that compile, own or control data the teams will need in applying the constraints analysis methodology. Such consultations may include national ministries of finance, transportation, public works, energy, education, health, labor, trade, agriculture, social or community development or gender, the central bank, the bureau of statistics, and local chambers of commerce or specific businesses, or business associations or civil society organizations. Through these consultations, the constraints analysis team should share information on the constraints analysis methodology, the data and information required and how the data and information will be handled. In addition, the constraints analysis team should establish a point of contact through which to channel communication and requests for data.

After a work plan has been established and key information needs have been identified, team members may begin collecting additional data through interviews or focus groups with experts or representatives of specific demographic, social, professional, or occupational groups. The constraints analysis team can use feedback from these stakeholders to identify additional concerns and to adjust its preliminary findings.

This information is useful and necessary for the analysis, but caution should be taken not to place too much weight on the consultations as the sample is not likely representative of the population overall.

The constraints analysis team should undertake a subsequent set of consultations after its preliminary analysis of the available data and information has ruled out certain potential issues or concerns. The constraints analysis team should identify key questions that are necessary to address in order to complete the constraints analysis. These consultations should target stakeholders who can provide information and/or evidence that the constraints analysis team could use in order to deepen the analysis, rule out additional constraints, and arrive at near-final results. These consultations should investigate how stakeholders in different groups perceive constraints; provide additional information that can strengthen the analysis; and/or resolve outstanding questions or explain conflicting information.

Consultations may involve a variety of stakeholders, including those in different regions of the country (perhaps representing urban and rural areas, or coastal and inland areas), those in formal and informal business enterprises, women-run businesses, civil society organization, internationally-owned firms, and those active in different sectors and industries. For these consultations, the depth of discussion may be more important than the number of respondents in each category. For that reason, individual or small group discussions are likely to be preferable to large roundtable meetings.

Consultations should be jointly planned and agreed upon in advance by the members of the constraints analysis team. The team should generate lists of targeted questions or themes for discussion for each stakeholder consultation in order to ensure that all topics of analytical interest are covered in a single session – economic, private sector, social – to the extent possible. Where possible, all constraints analysis team members should be present for consultations to ensure that team members are extracting the information that is relevant to their particular analytical lens. It should be possible to interview a large number of stakeholders over the course of several weeks. The constraints analysis team can use feedback from these stakeholders to identify and research additional information and data.

Finally, the constraints analysis team should undertake a third set of consultations after it has reviewed the conclusions on a set of binding constraints or prepared an initial draft of its constraints analysis report. Such consultations may take place at various locations across the country and involve a broad set of stakeholders, to include non-governmental/civil society organizations, and community-level participants. These consultations help disseminate information about the results of the constraints analysis process, but they should also provide validation and general agreement on the binding constraints. The consultations may also provide further nuance to the conclusions or highlight prioritization or even disagreement among various groups affected by the binding constraints. In this way, feedback from these consultations may be relevant in the next stage of compact development, as the selected country begins to examine the binding constraints in greater detail.

Drafting the Constraints Analysis Report: As a general rule, the economist will manage the process of sorting data and information and writing the final constraints analysis report, with participation by the other team members. To support that process, the team should, as early as possible, develop an outline for the report that emphasizes conclusions regarding the binding constraints while integrating a range of insights and findings on social and gender and industry level issues. The team may also begin with a visual

presentation instead of text documents to document and communicate its analysis. The final constraints analysis report should include, at minimum, three general sections: a context section, the diagnostic tests, and a synthesis or concluding section. The context section should include a history of growth and poverty reduction of the country that details and explains key drivers of past growth and the distribution of that growth in the country's specific context. The diagnostic tests section should apply the constraints analysis methodology and present evidence used to determine whether a potential constraint is binding or non-binding, with additional contextual data and consideration for whether and how the binding constraint(s) affects certain economic sectors of interest or its effects are felt differentially among social groups. The synthesis or concluding section should, to the extent possible, delve into the underlying causes of the identified constraints and consider the potential to relieve the constraint and impacts for growth and poverty reduction if the constraint were to be relieved.

In many cases, the constraints analysis team may begin writing initial drafts of the report even before it has finalized its identification of the binding constraints to economic growth. It may wish to draft sections of the constraints analysis report on an iterative basis by seeking discussion and feedback on preliminary findings and conclusions from the MCC country team or by seeking guidance on additional data and information. Wherever relevant, the report should reflect context provided by the social and gender information and sector-level and industry-level information that the constraints analysis team has collected and analyzed. The final version of the report should also incorporate feedback from the last round of consultations and, for that reason, may not be produced until after the six month target.

Although the constraints analysis may be developed collaboratively, the selected country should “own” the document, which will form an important basis for additional work during later steps in the compact development process. This generally means that the constraints analysis team should take the lead on designing and conducting the analysis and assume responsibility for its results. Additionally, the analysis should be understood by a diverse group of stakeholders, and effort should be made to socialize the results across a wide-cross section of the country and build broad-based support for its findings. Once it is finalized, MCC strongly encourages that the selected country make the final draft of the constraints analysis report publicly available on the internet.

Chapter 4: Guidelines for Public Consultations and Stakeholder Engagement

Both the experience of development practitioners and the literature on economic development confirm that the participation of stakeholders in the development process leads to programs that better reflect national priorities and have a higher likelihood of success. MCC is committed to this principle of direct engagement through the requirement that each selected country undertakes a timely, participatory and meaningful process of consultations with key stakeholders who are likely to be affected by the development and implementation of proposed compact programs. This requirement reinforces MCC's commitment to accountability throughout the development process, improves the design of compact programs, strengthens relationships between each selected country and key stakeholders who are essential to the success of project implementation, and improves the long-term sustainability of a compact program's results.

Requirements for public consultations and stakeholder engagement

Throughout the compact development process, MCC must ensure that each selected country has engaged in a process of public consultation and stakeholder engagement that includes civil society organizations, the international and domestic private business community, and other international development agencies, among other stakeholders. MCC also must ensure that each selected country has gathered information about the poor, disadvantaged and marginalized populations – including women – and taken their perspectives into account in the development of its compact program.

These principles inform a series of policies and procedures that apply to compact development. The *MCC Environmental Guidelines* require that compact projects are developed and implemented in ways that conform to the International Finance Corporation (IFC) Performance Standards on Environmental and Social Sustainability. IFC Performance Standard 1: *Assessment and Management of Environmental and Social Risks and Impacts* defines standards by which selected countries must disclose relevant information, identify and engage stakeholders, allow meaningful opportunities to participate and express views, and document the results of consultations.

In addition, the *MCC Gender Policy* requires that consultations be designed and implemented to allow both women and men meaningful opportunities to participate, that selected countries utilize gender analysis in involving stakeholders, and that selected countries provide evidence of participation in consultations throughout the compact development process.

Defining a public consultation and stakeholder engagement process

Public consultation and stakeholder engagement can be any communication about the proposed compact program that takes place between the selected country and one or more stakeholders. To be part of a

consultative process, however, such communications should be part of an ongoing, two-way dialogue that is strategically planned, organized, and implemented for the purpose of gathering and disseminating information. Selected countries should view stakeholder consultations as an opportunity to improve each stage in the compact development process, rather than a tool or procedure designed simply to validate or confirm particular positions.

This goal is accomplished through two types of communication. First, selected countries engage stakeholders to disclose and disseminate information about the compact development process, the findings of the preliminary analyses, the concepts or ideas under consideration, the proposed projects, and the agreed compact program in a way that is timely, relevant, transparent, objective and meaningful. This type of disclosure ensures that stakeholders are fully aware of opportunities to participate in the development process and have sufficient time to consider the issues and formulate views. In the initial stages of compact development, information can be made available through a variety of channels such as targeted meetings with key stakeholders, larger public gatherings, on the internet, in the local print media or over the radio or television. At later stages of compact development, direct meetings with individual or small groups of potential beneficiaries or project-affected persons also may be convened.

Second, a selected country consults stakeholders to expand the range of data and evidence at its disposal and ensure that its decisions are based on the best available information. By actively seeking opinions, ideas, and expertise from stakeholders, a selected country gains access to a wide range of empirical inputs. Some inputs may be dissenting or even critical, but the diversity of inputs allows the selected country to challenge its initial assumptions, detect unintended consequences or other weaknesses, identify alternative courses of action, and obtain a clearer understanding of the broad national interests at stake. These adjustments enhance the selected country's ability to make assessments, understand or prioritize results, or formulate concepts or proposals at each critical decision point, thereby raising the quality of its work throughout the compact development process.

Through consultations of these types, each selected country can establish constructive relationships with a variety of external stakeholders and maintain those relationships over time. The active engagement of stakeholders increases their sense of ownership and commitment to key decisions and outcomes leading up to the agreement and implementation of a compact program.

Planning and capturing public consultations and stakeholder engagement

After the selected country appoints a Compact Development Team, one of its first actions should be to develop a clear, comprehensive *Public Consultation and Stakeholder Engagement Plan*. The plan should put forward a system for consulting and engaging stakeholders that makes sense in the unique social, political, and institutional context of the selected country. Among other details, it should lay out general principles of transparency and openness; identify key groups of stakeholders; indicate the timeline on which they will participate; explain the methodology by which the selected country will consult them; define a mechanism for sustained, ongoing consultation; and set a general expectation that the results of public consultations and stakeholder engagement will be captured and documented. Because the location of specific compact projects will not yet be known, the plan also should outline a strategy to identify

additional, relevant stakeholders once the targeted areas are more clearly understood.

The nature and frequency of stakeholder engagement may vary depending on the phase in the compact development process and the nature of the proposed concepts or projects being discussed. Under any scenario, however, the plan should ensure that engagement includes all relevant stakeholders with an interest in the outcome of the compact development process. Such stakeholders may include international development partners, such as the World Bank and other multilateral donors, bilateral donors, and private philanthropic organizations; public entities, such as national ministries and agencies, academic institutions, think tanks, and local governments; private business organizations, such as chambers of commerce, small business associations, trade or industry groups, individual companies and labor unions; civil society organizations, such as advocacy organizations for government transparency or accountability, environmental protection organizations, organizations dedicated to economic development or regional development interests, consumer advocacy organizations, professional organizations, social welfare organizations, organizations that represent the interests of women, organizations that represent the interest of the poor or minority populations, religious associations, and other non-governmental organizations.

To meet MCC's rigorous standards, stakeholder engagement must include both women and men and be accessible to disadvantaged social groups within the selected country. The Compact Development Team's plan should pay particular attention to any norms, societal practices, or legal barriers that may impede meaningful participation by persons of either gender, should acknowledge any risks of gender discrimination or inequality, and should propose specific measures to ensure equality of opportunities to share experiences, access information and provide feedback. In some cases, such measures may include the need for a separate consultative process with women, the poor, or other disadvantaged groups.

MCC will review and approve each Public Consultation and Stakeholder Engagement Plan to help ensure the participation of a broad and diverse group of relevant stakeholders.

Consultations in the Preliminary Analysis phase

Effective consultation is a two-way process that should begin as early as possible. For that reason, MCC encourages each selected country to initiate a consultative process early in the Preliminary Analysis phase to raise awareness of the country's selection to develop a compact program, to explain the standards and requirements of selection, and to manage expectations about the timing, size and potential impact of a compact program.

At the same time, the selected country should begin engaging key stakeholders to introduce the Compact Development Team, outline the compact development process, and explain how critical decisions about the compact program will be made. This will inform stakeholders so that they will know how and when they can participate and how decisions will be made.

Once the selected country has initiated its analysis of constraints to economic growth, it should consult various stakeholders to understand their perspectives on impediments that restrict access to economic opportunities, distort equitable sharing of economic benefits, or otherwise restrict economic growth. Such

consultations should include academic experts; business leaders and small and medium business owners; various trade and industry groups; and women and men of different ages, social classes, ethnicity, religion, and other social differences. As results from the constraints analysis become available, the selected country should validate those results with groups of key stakeholders. Information gathered through such consultations should contribute directly to the selected country's final identification and prioritization of obstacles and sectors for further assessment and potential intervention.

Public Consultations and Stakeholder Engagement in later phases of compact development

Each selected country should continue stakeholder engagement throughout the remainder of the compact development process, taking care to follow up consistently with stakeholders that it has previously engaged while continuously evaluating the need to engage additional stakeholders as the process moves forward. Tailoring consultations to each phase of compact development enables stakeholders to describe economic and social obstacles they experience; discuss potential solutions that would work in a local context; highlight flaws in previous efforts to address these challenges; debate the technical design and requirements of new proposals; and provide feedback about the impact of a compact project as it is implemented. It also provides the government with a forum in which to explain what decisions have been taken and why. Specific standards for each phase of the compact development process are discussed in the relevant portions of the chapters that follow.

In particular, in preparing its Concept Notes and Project Proposals, each selected country should explain how it gathered and assessed stakeholder inputs on its proposed concepts and proposed projects. MCC also may request that a selected country produce a written *Stakeholder Engagement Report* to provide an overview of its stakeholder engagement process, catalogue the type and number of stakeholders consulted, capture stakeholder inputs, and explain how those inputs were used to improve the quality of key decisions and documents in the compact development process.

Chapter 5: Expansion of the Compact Development Team

Once agreement is reached on the binding constraints to economic growth, the selected country will transition into the Problem Diagnosis phase, the stage of the compact development process that involves detailed assessment of the underlying root causes of the binding constraints, the formulation of a detailed logic for proposed interventions, and the submission of preliminary Concept Notes.

To initiate the transition, MCC expects each selected country to fill the additional positions on its Compact Development Team as quickly as possible to gain access to the skills sets and areas of expertise that will be needed through this phase and beyond.

Monitoring and Evaluation (M&E) specialist: Each Compact Development Team should include an M&E specialist who will take the lead in building a framework for measuring the progress and the results the agreed compact program. In the secondary stage of compact development, the M&E specialist will participate in the team's detailed analysis of the core problems that underlie the binding constraints, and facilitate the Compact Development Team's efforts to develop a clear program logic – based on data and other evidence – that underlies any proposed concepts. As the selected country moves toward specific proposed investments and other activities, the M&E specialist will identify indicators and evaluation methods by which progress and results can be measured, develop a detailed data collection strategy, gather and assess the quality of relevant data and information, and document baselines and performance targets for proposed projects. In later stages of the compact development process, the M&E specialist will develop and implement a comprehensive Monitoring and Evaluation Plan, and design approaches for the rigorous evaluation of each investment within the agreed compact program.

Strong candidates for the M&E position will have an advanced degree in statistics, economics, economic development, public policy or a related field. They will typically have considerable experience developing research strategies, designing surveys and other data collection tools, collecting and assessing the quality of data, as well as experience building monitoring and evaluation frameworks and administering impact evaluation and performance evaluation studies, in many cases with international development partners.

Environment and Social Performance specialist: Each Compact Development Team should also have an environmental and social performance specialist who will take the lead in identifying, assessing and managing any environmental and social issues associated with the proposed compact program. In the secondary stage of compact development, the environmental and social performance specialist will participate in the team's detailed analysis of the “root causes” that underlie the binding constraints, helping identify both underlying environmental and social issues as well as potential interventions. At the same time, the environmental and social performance specialist will work closely with the public outreach and stakeholder engagement specialist to advance and implement the selected country's strategy for public consultations and stakeholder engagement. As the compact development process moves forward, the environmental and social performance specialist will take the lead in developing the selected country's strategy for assessing and understanding potential environmental and social risks and mitigation measures associated with proposed investments and other activities, and at later stages will also assess the capacity

of the government agencies or other entities that may be involved in the oversight or implementation of the proposed compact program to manage critical environmental and social issues.

Strong candidates for the environment and social performance position will have an advanced degree in natural science, environmental planning, environmental management, environmental engineering, natural resource management or other relevant field. They will typically have detailed knowledge of the selected country's environmental laws and regulations, as well as prior experience in preparing, reviewing, managing or overseeing environmental permitting or environmental and social impact assessments, in many cases with international development partners. Familiarity with the World Bank's Operational Policy (OP) 4.12 and the International Finance Corporation (IFC) Performance standards is strongly preferred.

Legal counsel: Each Compact Development Team needs legal counsel typically beginning from the time concepts for compact development have been identified and extending through negotiation and signing of the compact. Legal counsel is responsible for advising the Compact Development Team and the government of the selected country on all legal issues relating to the compact, including the obligations to be assumed by the government under the compact and legal matters affecting the projects to be funded under the compact. In addition, legal counsel will, among other things: advise the Compact Development Team on legal issues as they arise; act as the main liaison between the Compact Development Team and MCC's Office of the General Counsel; determine the need for additional legal experts (possibly including outside legal counsel), identify possible sources for such experts, and manage any such experts employed; advise the Compact Development Team regarding employment matters, including drafting and negotiating any necessary employment agreements; provide guidance on legal implications of procurement or financial activities that may be undertaken by the Compact Development Team; and fulfill such other responsibilities as are commonly exercised by, or incidental to the position of, legal counsel for a similar entity or as may be delegated or assigned from time to time by the National Coordinator.

Strong candidates for the legal counsel position will be qualified to practice law and otherwise provide legal advice and services under the laws of the relevant country and have the authority to represent the government in all phases of compact development. Legal counsel should have extensive familiarity with the public laws of the relevant country, as well as the international laws affecting the government and the requirements for international agreements. Counsel meeting these qualifications typically include attorneys within the ministry of justice, the attorney general's office, or a similar national governmental office. Additional qualifications for the legal counsel position include: experience representing the government, especially in transactions or situations involving foreign investors or bilateral or multi-lateral transactions with foreign governments; experience advising entities in negotiating, executing, and implementing international agreements with foreign governments; experience representing parties in the formation, organization, governance, and administration of legal entities in the country, especially entities that perform a governmental or charitable function; experience in government procurement and contracting; experience in administering or providing advice regarding tax exemptions under the country's laws; excellent oral and written communication skills; the ability to work under pressure and against tight deadlines; and fluency in spoken and written English.

Sectoral specialist(s): Each Compact Development Team should also have at least one technical specialist for each of the technical, commercial, or industrial sectors in which it expects to propose concepts and pursue potential investments or other activities. Such specialists may include agricultural economists, agronomists or other specialists involved in agricultural projects; education or pedagogical specialists involved in skills training or other education sector projects; doctors or public health specialists involved in disease control or other health care projects; civil engineers involved in construction, water and sanitation, transportation or other similar projects; electrical or mechanical engineers involved in electric power projects; and a wide range of other specialists. In the secondary stage of compact development, the sectoral specialists will provide detailed information on any new investments or other developments, trends or significant issues in their primary sectors, and will participate in the team’s detailed analysis of the “root causes” that underlie the binding constraints, and will take the lead in crafting – and proposing – concepts designed to address those root causes. In later stages of the compact development process, technical specialists typically design terms of reference, solicit bidders and manage consultants and contractors through the full development of proposed investments and other activities.

As a general rule, strong candidates for sectoral specialist position generally possess an advanced degree in a relevant field of academic specialization, and have ten (10) or more years of professional experience managing large-scale investment projects to ambitious timelines and budgets. Such candidates typically exhibit considerable knowledge of the policies, institutions, and reform priorities for the relevant sector, as well as any relevant strategies, sector plans, or master plans. Deep familiarity with project development, including pre-feasibility or feasibility studies, cost estimating, design and construction supervision is strongly preferred.

As with other staff, the selected country may select national or international candidates and may hire staff on a part-time or full-time basis, as needed to secure the best talent while also meeting standards and completing work. No further expansion of the team typically is required after this stage of the compact development process.

Chapter 6: Guidelines for the Root Cause Analysis

Once the preliminary analysis and the initial stage of stakeholder engagement are complete, the selected country will begin to explore the range of underlying issues that give rise to the binding constraints to economic growth. To do so, the selected country will conduct targeted research and interviews and undertake a structured dialogue with stakeholders to ensure a clear understanding of the constraint and the range and nature of the underlying factors or issues that give rise to it. Through this *root cause analysis*, the selected country will begin the process of identifying and selecting specific issues that it could address through targeted investments and other activities. These specific issues will become the core problems that lie at the heart of the Concept Notes, the first indication of what the selected country aims to achieve with a compact program.

The remainder of this chapter describes the rationale, process, content and standards for a typical root cause analysis in more detail.

Rationale

A well-designed root cause analysis serves as a critical bridge between the identification of broad binding constraints and the selection of specific issues around which Concept Notes – and eventually proposed projects – can be constructed. Of course, a strong root cause analysis does much more than help a selected county achieve greater focus. It also supports the following goals:

- Generates engagement with a wide array of stakeholders and raises awareness of their different perspectives on the binding constraint and its underlying drivers, leading to a more complete understanding of the issues at stake;
- Separates discussion about the symptoms and manifestations of a problem from analysis of its underlying causes;
- Breaks large, complex, economic development problems into smaller components that can more easily be analyzed, addressed, and managed;
- Builds logical thinking about the cause-and-effect relationships between various factors that contribute to a problem, leading to a framework for understanding where change must occur;
- Compels stakeholders to discuss a wide range of underlying causes, including the role of policies and institutions and the reasons for limited funding and poorly functioning services;
- Helps identify areas in which data, evidence, or other information is needed to clarify the nature, extent, or underlying causes of a particular issue;
- Captures the understanding of the constraint, its underlying drivers and the root causes in a simple, visual representation that can easily be shared with others; and
- Facilitates identification and prioritization of underlying problems and issues that can be addressed through targeted investments and activities.

Preparation and participation

Typically, a Compact Development Team will prepare for a root cause analysis by conducting preliminary research and a series of preparatory interviews with a range of stakeholders to gain a clear, baseline understanding of the constraint and the economic sector or system to which it most closely relates. While

the nature of such preparations will vary, a Compact Development Team should use them to build an understanding of the perspectives: of public institutions that govern and organize the sector, subject matter experts, providers of goods and services in the sector, and users or beneficiaries. Preparations should also help the Compact Development Team build a solid knowledge of recent, ongoing, or planned efforts to address the constraint, whether by the selected country government, international development partners, or other actors.

Following these preparations, the Compact Development Team often convenes one or more workshops to foster structured dialogue about the binding constraint and its underlying drivers. A workshop typically brings together stakeholders who are carefully selected from different backgrounds to reflect an array of views and experiences with various aspects of the constraint. Such stakeholders may be drawn from government agencies, universities or research institutes, industry groups or private companies, utilities or other service providers, consumer groups or end users, non-governmental organizations, local officials, or target beneficiaries. International development partners may also make good participants, given their outside perspective and knowledge of conditions in other countries.

To frame the dialogue, the Compact Development Team may find it useful to disseminate some of its initial research and interview findings, in an effort to ensure that all participants in the workshop share a basic understanding of the problem. For this purpose, information on various aspects of the sector or the systems in question may be useful, including relevant laws and policies, the governance and oversight structure, the roles and responsibilities of various public agencies (and in many cases, private companies) that operate in the sector, the role of the sector in the overall economy, the geographic extent or range of services provided to end users, the costs of service provision, the financial condition of utilities or public sector corporations and other technical information, such as estimated levels of technical losses in an electricity or water system or a catalogue of road conditions for a transportation system.

Conducting the root cause analysis

During the workshop, stakeholders discuss the relevant binding constraint identified through the constraints analysis. To start, they often reframe, clarify or refine the binding constraint into a clear, straightforward problem (known as the *focal problem*) that lends itself to detailed analysis. They then begin to break down the broad constraint into its component parts by posing the question: what causes the problem? Through discussion, dialogue and debate, they ultimately reach agreement around a series of smaller, underlying, causal factors, and through further questioning, proceed to break each of those factors into its underlying causes. They continue with this cause-and-effect analysis until they expose the root causes of the binding constraint.

In pulling apart broad bindings constraints in this way, stakeholders help reveal the unique nature of the problem their country confronts. For instance, in a country where unreliable electricity is a binding constraint, stakeholders may help determine that the power utility's overloaded transmission lines and outdated equipment are an important contributing factor. Pushing the analysis further, they may note that persistent underfunding of periodic maintenance explains the utility's poor maintenance, and that extremely low tariff levels are a root cause of the problem, because they allow the utility virtually no budget to invest in new equipment. Yet in other countries with a similar binding constraint, stakeholders

may find very different underlying drivers and root causes. For instance, in one country, stakeholders may find that the power utility has state-of-the-art equipment and a regular schedule of periodic maintenance, but that it relies heavily on generation from hydropower facilities concentrated along the main river. Pushing the analysis further, they may note that rapid deforestation along the river has exacerbated variability in the river flow and contributed to silting up the hydropower dams, thus explaining periodic dips in electricity supply. And in a second country, stakeholders may find that sharp peaks in demand for electric power are an important driver of unreliability, requiring more power than the electric grid was set up to support. Pushing the analysis further, they may note that big, inefficient factories make heavy demands on the power system in the late afternoon and evening, at the same time that household demand rises as employees return home from their daily jobs to turn on stoves, washing machines, air conditioners, and other household appliances. In this way, root cause analysis can lead to very different insights into constraints that may seem – at least on the surface – to be very similar.

Beyond disaggregating binding constraints along logical lines, the root cause analysis may also help shed light on the relative weighting or importance of its different underlying drivers. To achieve this end, the Compact Development Team should encourage stakeholders to provide as much data and evidence about the underlying issues and problems as possible. Where sufficient data and evidence is not available, however, stakeholders should note the need for additional information and continue their analysis. Later steps in the process will provide opportunities to collect, generate and validate additional information, where necessary to further understand the nature of the underlying issues.

The specific methodology for this kind of root cause analysis can vary. The Compact Development Team may look to other economic development agencies or international development partners for useful tools or frameworks for the root cause analysis. For example, the Asia Development Bank (ADB) and the German Gesellschaft für Technische Zusammenarbeit (GTZ) use a *Results-Focused Project Design* strategy, commonly known as a “problem tree” approach. The United Kingdom’s Department for International Development (DFID) employs a *Systems Analysis* strategy to assess systems that underlie complex economic development issues. And other organizations are following the lead of technology and consumer goods companies by employing *Participatory Design* or *Human Centered Design* strategies for continuously testing and refining their understanding of developmental challenges with end users and target beneficiaries.

In the end, the root cause analysis should generate a detailed understanding of a binding constraint, including clarity on the range of underlying drivers and root causes that give rise to it. This understanding should be documented in a simplified, visual format that clearly and easily conveys the root causes and the cause-and-effect relationships by which they lead to the binding constraint. One such representation is a *problem tree*, a graphic representation that depicts the focal problem in the center as the trunk, with layers of underlying causes as roots and effects or implications above as branches.

Timeline and results

The Compact Development Team should aim to start the root cause analysis as soon as possible after the identification of binding constraints. To do so, it must move quickly to recruit additional staff, including an M&E specialist, an environmental and social performance specialist and relevant sector specialists (as

described in Chapter 5). These additional staff will be instrumental in conducting initial research and background interviews.

The Compact Development Team should aim to conduct its first stakeholder workshop within two (2) months following the identification of binding constraints, to dedicate some time to validating the root cause analysis with various groups of stakeholders, and to finalize its problem tree or other visual representation not more than a month later. This will allow the team to identify one or more core problems and then quickly to begin developing and drafting Concept Notes for submission to MCC (as described in Chapter 7).

Chapter 7: Guidelines for Developing Concept Notes

Template

[Concept Note for Proposed Projects in an MCC Compact Program](#)

Following its analysis of root causes, a selected country identifies and selects from among them one or more critical issues that drive or contribute most heavily to the specific binding constraint. These critical issues are *core problems*. For each core problem that it identifies and wishes to address through a compact program, the selected country's Compact Development Team will develop and submit a short, written proposal, or *Concept Note*. Each Concept Note should explain the core problem and its root causes, offer a broad outline or strategic approach designed to resolve or address it, and define the primary objective.

These aspects—problems, approaches and objectives—form *concepts*, the foundations upon which more detailed projects can later be proposed and developed. When agreement on these concepts is reached, then, both the selected country and MCC can confidently add staff and release other technical resources for the next stage of the compact development process, in which the agreed approaches will be developed into a set of specific activities and investments. The selected country will present these to MCC in detailed Project Proposals (as described in Chapter 9).

Taken together, Concept Notes create an opportunity for dialogue between the Compact Development Team and MCC about the purpose, direction, and scope of the proposed compact program well before substantial amounts of time, funding or other resources are invested. This dialogue should help focus the proposed compact program on the most critical issues or problems among those that the selected country has examined and proposed. It should also build agreement on the specific core problem(s) the most promising or viable approaches to address these problems, and the corresponding objective that these approaches aim to achieve.

The remainder of this chapter describes in more detail the rationale, required content, and process of review for Concept Notes.

Rationale

A selected country's Concept Notes serve a range of purposes in the compact development process. Among these purposes, each Concept Note should:

- Pinpoint a *core problem* that the selected country wants to resolve through a compact program, articulate it in a clear *problem statement*, explain how it relates to one (or more) of the binding constraints identified in the constraints analysis, and describe its extent and its impact on key populations;
- Explain the underlying root causes of the core problem and provide *data and evidence* that

- demonstrate a full understanding of their impact, importance and weight;
- Present a *broad outline or strategic approach* that the selected country expects to pursue in resolving the core problem;
- Identify the *primary objective* that selected country expects to achieve by addressing the core problem and articulate it in a clear *objective statement*;
- Offer a clear *theory of change* that explains the cause-and-effect process by which the strategic approach, if implemented, will address root causes and resolve the core problem; decrease costs, add value or increase incomes among targeted beneficiaries; and thereby contribute to MCC's objectives of stimulating long-term sustainable economic growth and reducing poverty;
- Provide additional context on the selected country's existing strategies, plans and policy and institutional reform goals to address the core problem, as well as the success or failure of any recent activities undertaken by the selected country's government, international development agencies, or other organizations.

Selection of Concept Notes

A selected country need not develop concepts for each of the binding constraints identified in the constraints analysis. However, for those binding constraints that the selected country wishes to pursue, it should expect to identify a number of problems that contribute to the binding constraint through the analysis of root causes (as described in Chapter 6). MCC encourages the selected country to prioritize the one or two as core problems that contribute most heavily to the binding constraint and demonstrate the greatest potential for being resolved or addressed through a compact program. The selected country's Compact Development Team should develop each of these high-priority core problems into a separate Concept Note for submission to MCC.

In cases where the constraints analysis identifies cross-cutting issues or where two or more of the binding constraints to economic growth are very closely intertwined, the selected country may also identify core problems that address more than one constraint simultaneously. These may also be developed into Concept Notes for submission to MCC.

Required content and sources of information

In developing Concept Notes, the selected country's Compact Development Team should draw upon multiple sources of information to present evidence, form strong arguments and build a compelling logic. Sources of information may include detailed findings from the constraints analysis, which should contain a wealth of socioeconomic, microeconomic and macroeconomic data; the results of public consultations with government specialists, trade and business groups, civil society organizations and potential beneficiaries on the impact of binding constraints; the root cause workshops, in which a variety of stakeholders with particular knowledge of the key issues help the Compact Development Team analyze issues that underlie the binding constraints, develop detailed "problem trees" or other logical frameworks to represent those underlying issues, and identify where questions or data and information gaps remain; and other reports or analyses on relevant markets, sectors or industries that may be available.

In addition to these sources, the Compact Development Team is also encouraged to reach out to economic planning and development specialists, academics, researchers, sector specialists, private

companies, consultants and international development agencies to collect data, reports, assessments and other information that will help shed light on similar experiences in other countries, lessons learned from prior efforts to address the problem, international best practices, and any other project work that is ongoing or planned for implementation in the near future.

These sources of information should allow the Compact Development Team to define a core problem that drives or contributes heavily to a particular binding constraint to economic growth, and to define a broad strategic approach that will address the root causes and resolve the core problem. The information should also allow the Compact Development Team to articulate a clear primary objective that it expects to achieve by resolving the core problem, including how the objective will stimulate economic growth and reduce poverty.

In drafting its Concept Notes, the Compact Development Team should take care to present the required information in the template for Concept Notes, in form and substance similar to the template attached below. Concept Notes should be written in a concise manner that focuses squarely on the argumentation, information and data that MCC requests without a substantial amount of additional information. To ensure that MCC is able to undertake its own review and assessment efficiently, each Concept Note should be between five (5) to ten (10) standard pages. If absolutely essential, a limited amount of supplemental information may be added to each Concept Note in the form of attachments or appendices.

To supplement this guidance, MCC can provide the selected country with helpful materials, such as a list of guiding questions and an example of a well-written Concept Note.

MCC review and assessment

As soon as a selected country submits its Concept Note(s), MCC will begin a detailed review and assessment to determine which proposed concepts should be further developed into detailed Project Proposals. The MCC country team will remain in close contact with the selected country's Compact Development Team throughout this process, and MCC may request clarifications or supplemental information to ensure a common understanding and facilitate a full and accurate review.

MCC's review and assessment will be based on the clarity, depth and coherence of the contents, as well as the likelihood that a project based on the concept will meet MCC's criteria for investing MCC resources, commonly known as the "*MCC Investment Criteria*". The MCC Investment Criteria require that each project:

- *Aims to alleviate root causes of a binding constraint.* MCC expects the compact programs it supports to reduce the most critical impediments to a selected country's long-term economic growth, as identified in the constraints analysis. To encourage such a focus at this early stage, MCC will examine each Concept Note to ensure that it reflects a complete understanding of a binding constraint; identifies a core problem that is critical to resolving the binding constraint and specifies its root causes, as supported by data, evidence and economic development experience; outlines an approach that will comprehensively address root causes and thereby resolve the core problem; sets a reasonable primary objective; and presents a clear, logical theory of change that explains how resolving the core problem will achieve the objective and lead to long-term economic growth.

- *Generates high economic returns:* MCC expects each project it supports to generate economic benefits that significantly exceed its costs. To encourage projects that have a high likelihood of generating positive economic returns, MCC will examine each Concept Note to ensure that it identifies and explains potential benefit streams that are likely to reduce costs, add value or increase incomes; that are likely to be broadly shared; that can be measured; and that economic development experience suggests may outweigh costs. MCC does not expect detailed calculations of the cost-benefit ratio or the economic rate of return at this time.
- *Allows full implementation within a five-year compact term:* MCC's compact programs are strictly limited to an implementation period of no more than five years. To prevent further work on concepts that are unlikely to meet this tight timeline, MCC will look closely at this early stage at the nature and complexity of the proposed concepts; the selected country's implementation experience and management capacity; the quality of the existing institutional framework in the selected country; and lessons learned from international work in similar sectors, among other factors.
- *Represents country ownership of both the problem and the solution(s):* MCC believes that economic development assistance is most effective when it strengthens the relationship between a selected country's government and its citizens, reflects the selected country's own priorities, and augments the impact of other development projects and plans. To reinforce this belief, MCC will review the compact development process and examine each Concept Note to ensure that the proposed concepts reflect a commitment of political and economic resources from the selected country; incorporate timely, participatory and meaningful consultations with civil society and the private sector; link closely to the selected country's poverty alleviation, economic development and sector investment plans; and take account of the experiences and plans of other international development partners.
- *Complies with the MCC Environmental Guidelines and the MCC Gender Policy:* MCC recognizes that economic growth and poverty alleviation can only be achieved when the natural environment is protected and the participation of women, the poor and disadvantaged social groups is ensured. In accordance with its Environmental Guidelines and Gender Policy, MCC will examine each Concept Note at this early stage to ensure that gender, social and environmental considerations have been fully taken into account, particularly with public consultations and the root cause analysis.
- *Supports the long-term sustainability of results:* MCC expects its compact programs to continue providing benefits to selected countries long after a five-year compact program comes to a close. To do so, compact programs must be designed and implemented for long-term sustainability. At this stage, MCC will examine each Concept Note for indications that problems can be addressed and solutions sustained over the long-term, with particular emphasis on the selected country's willingness to address institutional, regulatory, legal and policy issues that may contribute to inefficiencies or reduce benefits.

In addition to these required criteria, MCC may also provide guidance on other criteria it will use in developing and assessing the proposed compact program in the next phases of compact development. That guidance may include encouragement to explore particular projects or design options that enhance opportunities for poverty alleviation, environmental benefits, private sector participation, or other aspects of the potential compact program in the next phase of the compact development process.

As a general rule, MCC will provide detailed, written feedback to the Compact Development Team within six to eight weeks after it receives a formal submission of the Concept Note(s). In its feedback, MCC will

identify the core problems, primary objectives and strategic approaches or frameworks that, in MCC's assessment, represent the greatest opportunities for further development. MCC is also likely to identify questions and concerns that the Compact Development Team should explore and address as it begins to develop more detailed Project Proposals in the next stage of the compact development process. In some cases, MCC may recommend removing certain elements of a concept or an entire concept from further consideration, if not supported by adequate evidence or sound logic, not likely to meet the MCC investment criteria, or otherwise incompatible with MCC's model. In other cases, MCC may offer recommendations to strengthen the definition of the core problem, the framing the primary objective, or refine the scope of the broad approach, or concept, based on its experience with the design and implementation of complex economic development projects.

Chapter 8: Guidelines for Developing Project Proposals

Template

[Project Proposal for a Project in an MCC Compact Program](#)

Through the development and submission of Concept Notes, a selected country constructs the rationale for its proposed compact program and works with MCC to reach agreement on the core problem, primary objective and strategic approach – the *concept* – at the heart of each proposed project. Once agreement on the concept is reached, the selected country's Compact Development Team will prepare and submit a *Project Proposal*, a detailed description of the specific components that make up the substance of each proposed project. Each Project Proposal defines the components, estimates their total costs, expands the preliminary theory of change into a more complete project logic that connects each component to a series of intermediate outputs and long-term impacts, identifies expected beneficiaries and begins to quantify the benefits they are likely to receive, indicates the conditions and timeline for their implementation, and highlights the full range of potential risks and other issues associated with the proposed project.

Project Proposals give the Compact Development Team an opportunity to clarify, elaborate, organize and further develop its initial concepts into a set of specific components explicitly designed to address the root causes of the core problem and achieve the agreed objectives. At the same time, the Project Proposals allow the Compact Development Team to provide more detailed arguments about the linkage between those components and the long-term goals of poverty reduction, increased income and economic growth, and to support those arguments with data and other evidence. Discussions between the Compact Development Team and MCC about the Project Proposals help ensure that the proposed approach, structure, and components are sound and that outstanding issues are fully identified before significant resources are invested in full development and preparation of the proposed projects through feasibility studies, environmental and social impact assessments, and other preparatory work.

The remainder of this chapter provides a more detailed explanation of the rationale, required content, and process of review for Project Proposal(s).

Rationale

The Project Proposals that a selected country submits to MCC serve a range of purposes in the process of developing a compact program. Among these purposes, each Project Proposal should:

- Refine and sharpen the specific *core problem* that the proposed project will address and the specific *project objective* it will achieve;
- Describe the combination of specific *components* that comprise a proposed project, including any physical construction or rehabilitation of “hard” assets along with “soft” investments in policy, legal and regulatory reforms, institutional capacity building, technical assistance and social and behavior

change and explain the current status of preparation of each component, and estimate the total cost of each;

- Present a detailed *project logic* that clarifies how the components will work together to address root causes of the core problem, and that links each proposed component to projected outputs, those outputs to anticipated intermediate outcomes, and those intermediate outcomes to the primary objective and the long-term goals of increased income, economic growth and poverty reduction;
- Identify the *expected beneficiaries* of the proposed project, specify the *economic benefit streams* that the proposed project is expected to deliver, and where possible estimate the total magnitude of expected benefits;
- Catalogue critical technical, economic, environmental, social and gender *issues and risks* that must be understood and mitigated before the proposed project can be considered for a final investment decision;
- Assess the likely *sustainability* of the proposed project and define any particular measures that may be necessary to strengthen the proposed project's viability or to enhance, expand or extend its expected economic benefits; and
- Propose specific *implementing entities* that will lead, manage or oversee the implementation of the proposed project.

Selection of Project Proposals

As a general rule, selected countries should expect to submit one Project Proposal for each concept that MCC has agreed to consider supporting through its assessment of and response to the original Concept Notes. In some cases, a country's Compact Development Team may decide to combine elements of more than one agreed concept into a single proposed project in an effort to take advantage of synergies, for example, where combining elements strengthens the program logic or raises the likelihood that a project will achieve the agreed objective. In such cases, the selected country should discuss options with MCC in advance and should clearly explain its decision in its written submission.

MCC encourages the Compact Development Team, as it develops each Project Proposal, to consider a variety of alternative approaches that may address the core problem and achieve the project objective, and then to test each against a range of factors, including its appropriateness in the local context and its likelihood of delivering the expected outputs and outcomes. The Compact Development Team should also be aware that some proposed activities (and in some cases, entire proposed projects) may not stand up to scrutiny during the Project Development phase or ultimately meet the rigorous MCC Investment Criteria.

At this stage of the compact development process, selected countries should refrain from developing Project Proposals for concepts not previously proposed and reviewed through Concept Notes, unless explicitly invited to do so by MCC.

Required content and sources of information

Before starting the process that leads to Project Proposals, a selected country's Compact Development Team should already have direct access to technical specialists who have extensive experience with similar

economic development projects or relevant economic or industrial sectors (as explained in Chapter 5). In most cases, these technical specialists will spearhead the writing of the Project Proposals, working in close collaboration with other members of the Compact Development Team.

In developing Project Proposals, the Compact Development Team should rely on the data, evidence, information, experiences and lessons learned that come from related economic development efforts – both within the selected country itself and in other, similar country contexts. Such efforts may have been supported by local governments, the national government, development banks or other public institutions or may reflect support from charitable organizations or international development partners. In many cases, trade or industry groups, business owners, domestic or foreign investors, and other private sector groups have experiences to share and constructive ideas to contribute. Ideas, assessments and proposals from academic institutions, civil society organizations, public policy think tanks, or other organizations may also be helpful.

The Compact Development Team should use a variety of methods to gather data, evidence and other information from these sources. MCC encourages the Compact Development Team to make use of its own technical specialists, who should be well-versed in the selected country's development experience and its future economic development plans. The Compact Development Team should also make use of the knowledge and expertise in the selected country's various agencies, departments, ministries and public enterprises. And MCC encourages the Compact Development Team to work closely and collaboratively with the MCC country team, which can share perspectives from MCC's own experience with planning, developing and implementing projects around the world.

Regardless of the source of information, the Compact Development Team must develop a well-organized, well-articulated Project Proposal that offers a set of specific investments and other activities that will effectively address the core problem and its underlying issues and achieve the objective of the agreed concept. In doing so, the Compact Development Team must present a strong project logic supported by data, empirical evidence and lessons from similar projects and developmental contexts. To maximize the opportunities for success, MCC encourages the Compact Development Team to develop and explain each proposal carefully and organically, rather than pulling "off the shelf" projects that were previously developed for very different purposes or audiences.

As a general rule, each Project Proposal should be between twenty (20) and thirty (30) pages and should follow the template for Project Proposals, in form and substance similar to the template attached below and otherwise available from the MCC country team or through MCA Collaborate website.

MCC review and assessment

As with Concept Notes, MCC will undertake a detailed review and assessment of the selected country's Project Proposals to ensure a common understanding of the components that merit the commitment of additional resources for full preparation and development during the next phase of the compact development process.

MCC's assessment will be based on the clarity, depth and coherence of the contents of each Project

Proposal, as well as the extent to which the proposed investments and other activities are likely to meet MCC's criteria for the investment of MCC funds, commonly known as the "*MCC Investment Criteria*". The MCC Investment Criteria require that each project:

- **Aims to alleviate root causes of a binding constraint.** MCC expects the compact programs it supports to reduce the most critical impediments to a selected country's long-term economic growth, as identified in the constraints analysis. MCC's assessment of proposed projects will be significantly more rigorous at this intermediate stage than at the Concept Note stage. MCC will look closely at the detailed project logic in each Project Proposal to determine if the proposed components directly and fully address the full range of root causes that give rise to the core problem and if successful implementation of the proposed project is likely to resolve the core problem and thereby alleviate the associated binding constraint. MCC will also examine the detailed project logic to ensure that social and gender issues, poverty reduction and benefit distribution are being integrated into the proposed components at this stage.
- **Generates high economic returns.** MCC expects each project it supports to generate tangible economic benefits that significantly exceed the project's total costs, as measured through a cost-benefit analysis that determines an economic rate of return (ERR). At this intermediate stage, each Project Proposal should distinguish the primary streams of economic benefits that the proposed project is expected to generate, consistent with the detailed project logic. The Project Proposal should also describe the data or other supporting evidence required to conduct a complete cost-benefit analysis for the proposed project, clearly identifying any missing data and laying out a plan for its collection and verification. Where possible, the Project Proposal should also provide an initial assessment or outlook for the potential ERR, based on existing data and key assumptions.
- **Allows full implementation within a five-year compact term.** MCC's compact programs are strictly limited to an implementation period of no more than five years. To support successful implementation, MCC at this intermediate stage will carefully examine the nature, sequencing and interdependencies of the proposed components in each Project Proposal to ensure that the proposed project can reasonably be started and completed within those strict limitations. MCC will also look closely at the current level of preparation for the proposed project, including resource requirements and timelines associated with completing full feasibility studies and environmental and social impact assessments, as well as related assumptions, issues and risks when assessing the implementability of the proposed project.
- **Represents country ownership of both the problem and the solution.** MCC believes that economic development assistance is most effective when it strengthens the relationship between a selected country's government and its citizens, reflects the selected country's own priorities, and augments the impact of other development projects and plans. As in earlier stages of the compact development process, MCC will look to the selected country for an ongoing commitment of resources in the development of the Project Proposals, including full staffing of the Compact Development Team and meaningful support from other, relevant government agencies, as well as continued timely, participatory and meaningful consultations with civil society organizations, the private sector, other international development partners, and people who are likely to be directly impacted by the proposed projects. MCC will examine each Project Proposal for indications that such consultations have been captured, assessed and taken into account in the proposed project. MCC will also examine each Project Proposal for evidence that it takes into account the development strategies, plans and priorities of other international development partners, as well as any complementary investments that may impact the results expected from the proposed project. Finally, MCC will also look for evidence that the proposed project fits within the selected country government's existing development strategies and sector development plans, the responsible

government agencies fully support the proposed components, and that the government is committed to the policy, legal, regulatory or institutional reforms that may be needed in the affected sector(s).

- Complies with the MCC Environmental Guidelines and the MCC Gender Policy. MCC recognizes that economic growth and poverty alleviation can only be achieved when the natural environment is protected and the participation of women, the poor and disadvantaged social groups is ensured. At this intermediate stage, MCC will closely examine each Project Proposal to ensure that environmental and social issues (including involuntary resettlement and land acquisition, as well as gender and social inequalities in the control of resources or the distribution of expected benefits) will be examined across the proposed project's full area of influence, that potential adverse risks are of a type or degree that can likely be avoided or mitigated, that the selected country plans to undertake rigorous environmental and social assessments to fully assess the potential impacts of all proposed components, and that the proposed project appears to have an acceptable risk profile overall.
- Includes clear metrics for measuring results. MCC supports projects that set clear, measurable goals and are designed to continuously monitor their progress and performance. To encourage well-designed projects, MCC will closely examine each Project Proposal to ensure that it identifies specific indicators, metrics or measures by which the interim results associated with each component and the impact associated with the project objective and explains their relationship to elements of the economic model. Where possible, the Project Proposal should also identify baselines and interim targets for the various indicators, or where those are not available, should describe a plan for collecting the relevant information and setting baselines and targets during the next phase of the compact development process.
- Supports the long-term sustainability of results. MCC expects its compact programs to continue delivering benefits long after a five-year compact program comes to a close. To do so, compact programs must be designed and implemented for long-term sustainability. At this intermediate stage, MCC will look closely at each Project Proposal to ensure that it identifies risks or impediments to long-term sustainability and explains an overall strategy for enhancing the legal or regulatory, institutional, social or behavioral, environmental or financial sustainability of the proposed projects. Such a strategy may include specific investments or other actions, such as the adoption of a new law, the creation of an independent regulator, strengthening of operations and maintenance regimes, tariff changes to fully cover costs, the strengthening of private sector activity, and enhanced physical resilience to the effects of climate change, among others.

In addition to these required criteria, MCC may have also informed the selected country that other investment criteria will apply to the proposed project, in recognition of the particular opportunities or trade-offs that the proposed project represents. In some selected countries, for instance, MCC may encourage project design approaches that generate the highest possible economic rate of return (ERR). In other cases, MCC may encourage approaches that direct larger shares of the expected benefits to poor segments of the population while recognizing that the absolute magnitude of benefits received by the poor per dollar investment is more important than the share received by the poor. Likewise, in some selected countries, MCC may encourage approaches that lead to private participation in the proposed project or that enable complementary private investment. Yet in other cases, MCC might encourage close work with other international development partners to leverage additional sources of public funding.

Whatever the case, MCC will use its assessment to ensure that Project Proposals reflect high standards of project design, including strong linkage from the core problem to the proposed investments and other

activities, supported by relevant data and evidence; a clear explanation of the expected economic benefits; a well-developed project logic that specifies intermediate outputs and long-term objectives; specific indicators for measuring the success or impact of the proposed project; clearly defined groups of beneficiaries, wherever possible disaggregated by income, gender and other demographic characteristics; and clearly defined issues and risks that present a reasonable risk profile.

The MCC country team will remain in contact with the Compact Development Team and may request clarifications or supplemental information to ensure a common understanding and facilitate a full and accurate review.

As a general rule, MCC will provide detailed feedback within six (6) to eight (8) weeks after the selected country's Compact Development Team formally submits its Project Proposal(s) to MCC. In its feedback, MCC will identify the investments and other activities that represent the best opportunities for full project preparation and development through feasibility studies and other preparatory work. In so doing, MCC may offer recommendations to strengthen the proposed project or increase its likelihood of success, based on its experience with the design and implementation of complex economic development projects within a rigorous results framework.

In many cases, MCC will be in position to offer another type of Compact Development Funding that allows the selected country to undertake some or all of the necessary feasibility studies, environmental and social impact assessments, and other analyses for the full preparation of agreed projects. This Compact Development Funding for Project Preparation is covered in the next chapter (see Chapter 9).

Guidelines for Economic and Beneficiary Analysis

Background

The Millennium Challenge Corporation (MCC) was established in January 2004 to promote sustainable growth and poverty reduction. Indeed, the legislation that created the new American foreign assistance agency states that the MCC is to “(1) ... *provide United States assistance for global development ... and (2) to provide such assistance in a manner that promotes economic growth and the elimination of extreme poverty and strengthens good governance, economic freedom and investments in people.*”¹

MCC’s overriding objectives of promoting economic growth and reducing poverty in our partner countries are closely connected. Evidence shows that the countries that achieved significant poverty reduction in recent decades also achieved significant economic growth. This strong relationship exists because economic growth is about income generation and, especially in poorer countries, the lack of income generation is one major reason behind chronic poverty.²

MCC does not simply assume that programs that stimulate growth will invariably reduce poverty, but instead looks at the likely distributive effects of proposals and, where possible, identifies the likely beneficiaries and the program’s impact on poverty. Ultimately, MCC seeks to fund activities that will generate significant and measurable increases in incomes of large numbers of people in our partner countries, including significant gains for the poor.

MCC analyzes the likely impact on economic growth of its programs by analyzing whether the proposed programs are consistent with international evidence on drivers of economic growth and by use of Economic Rate of Return Analysis (ERR).³ The essence of such an analysis is a straightforward comparison of costs and benefits, where the costs are the MCC-funded grants and the benefits are increases in incomes in recipient countries. Thus, MCC analyzes proposals as investments, with payoffs going to households and firms in partner countries.

The ERR analysis provides an estimate of the total increase in incomes attributable to a proposed MCC-funded activity relative to the total costs. Evidence from past work by MCC and others demonstrates a strong correlation between the amount of total benefits generated by an investment and the total amount of benefits gained by low-income households. The estimated increase in total incomes generated as part of the ERR analysis, however, does not distinguish among different types of beneficiaries and so cannot describe with precision the impact of a proposed project on the poor or any other specific population group. Beneficiary Analysis is an extension of ERR Analysis that seeks to *disaggregate* the total increase in income to determine specifically *which segments of society* will benefit from the proposed activities. Beneficiary Analysis can shed light on the merits of proposed investments in terms of promoting significant reductions in poverty. In selecting among several potential investment options, Beneficiary Analysis may provide important information to help identify preferred alternatives.

As a general objective, MCC policy is to seek proposals with high economic rates of returns and broad impact; in many cases, investments with high returns may also *reduce* inequality, enhancing the impact on poverty.⁴ We seek programs with both high poverty reduction impact and high economic returns at the

same time, rather than one or the other, and this approach excludes projects that promise high returns but do not benefit the poor. Country partners are expected to identify crucial constraints to growth and consider possible investments to ease those barriers to growth. MCC requires that countries analyze the economic impact of several options and select those proposals and project designs that have the highest impact on economic growth and poverty reduction for submission to MCC. The analysis of options and selection from these options should be part of the consultative process.

MCC's policy implies no preference over sectors and the use of economic rate of return analysis does not necessarily favor any particular sector, such as infrastructure, agriculture or health. Many of the projects proposed to MCC have been in agriculture and infrastructure, leading some to conclude incorrectly that MCC favors projects in these areas. In fact, MCC has no preference for sector or region, and a premature focus on one part of the country or economy may lead country partners to miss the potential investments that promise the highest return in growth and poverty. MCC's ERR analysis considers income gains over a relatively long term, typically 20 years, and so can capture the returns to investments in health and education that may accrue over a relatively extended period. To underline this point, Annex 1 describes three examples of health and education projects with high economic returns. In every case, however, the economic rationale needs to be assessed with a comparison of the cost of a proposed activity and the projected impact on local incomes.

MCC's policy of country ownership means that, through a consultative process, countries have the lead in proposing how funds should be used. MCC respects the ability of the country to analyze its own impediments to growth, and expects that governments will analyze options jointly with a wide array of stakeholders. MCC views its relationship with the countries as a partnership dedicated to the shared goal of determining where MCC funds can have the highest impact in raising incomes and fighting poverty. MCC reserves the right, however, to withhold approval for a proposal or parts of a proposal based on, among other factors, evidence of technical infeasibility, low economic returns (i.e., low *net* returns), weak supporting assumptions, low poverty reduction impact, or the lack of clear measurable benchmarks.

A number of studies have confirmed the tendency of analysis to be overly optimistic about project benefits before a project begins; for this reason, MCC prefers that evidence about a project's impact be drawn from evaluations of similar completed projects in the compact country or, if this is not available, results from another country with similar economic characteristics and conditions may be applicable. In keeping with our focus on results, MCC will not approve proposals or parts of proposals without good supporting evidence that the proposal will have a significant impact on economic growth and poverty reduction. Such evidence should be available when a country's proposal is presented to MCC.

In addition, MCC will come to agreement with the country on targets and a monitoring plan for each activity before the program commences. The M&E framework is directly linked to the economic analysis since variables from the benefit stream of the ERR analysis are included as key performance indicators and targets in the Monitoring and Evaluation Plan (M&E Plan). The purpose of this approach is to ensure that monitoring focuses on what is essential to producing a high economic impact. Since disbursements of MCC assistance will be conditioned on achieving benchmarks linked to the economic analysis, overly-optimistic economic projections are not recommended. The monitoring plan may also specify mid-stream changes in activities if the benchmarks are not being met. (See Guidelines for Monitoring & Evaluation

Plans for more detailed information.)

Guidance on calculating Economic Rates of Return (ERRs)

The economic justification for any proposed investment is assessed by comparing the likely benefits of that investment to total costs required to successfully implement the activity. This approach is similar to that taken by private sector firms when they decide whether to invest funds in a new for-profit venture, except public sector assessments consider the impact on a broader set of individuals (e.g., the country's entire population). As a public agency considering the likely benefits for its partner countries, MCC focuses on *micro-economic growth analysis* that estimates the expected increase in either incomes of people or value-added⁵ by individual firms in the country.⁶ This increase in incomes or value-added reflects the improvement in standards of living in partner countries that is MCC's primary goal; the distributional impact of these investments is formally considered in the Beneficiary Analysis (described below). The analysis of costs includes the MCC investment and any costs borne by local individuals or organizations.

A cash-flow analysis captures the value of the benefits relative to the value of these costs, but these net flows need to be discounted over time to reflect the opportunity cost of capital and the normal time-preference that people have for benefits sooner rather than later. The ERR, which is used as a summary statistic to describe the economic justification for the proposed investment, can be understood as the discount rate at which benefits exactly equal the costs of the proposed project.⁷ The higher the value of the benefits relative to the costs, the higher the ERR. Similarly, benefits that accrue sooner relative to the time when costs are incurred will also generate higher ERRs than projects with the same amount of benefits that accrue further in the future. In this sense, the ERR is a robust measure of a project's impact on the material standards of living in the partner country that takes into account the absolute amounts of costs and benefits and the pattern of both over time.

The with-project scenario is compared to a scenario in which the investment is not made, known as the *counterfactual*. This baseline for comparison should be as realistic as possible, capturing what is most likely to happen in the absence of the new investment. In this scenario, the funds used for the investment are devoted to other undertakings, thus generating some return. In the MCC context, the average rate of return that these funds are likely to earn is the average return on such funds in the partner country as a whole, captured by its hurdle rate. Investments in activities that promise lower returns can be seen not just as a sub-optimal choice, but rather as an inefficient allocation of capital for the economy that may lead to distortions that will slow rather than accelerate growth.

Estimating the costs of a proposed project is relatively straightforward, as these primarily depend on the project's design. Estimating project benefits is somewhat more complex, since a counterfactual scenario must be estimated to understand the project's impact. Outlined below are the four key steps used to estimate the ERR based on MCC's micro-economic growth focus. Briefly, these steps entail defining who the project will affect, what these individuals or firms' current income is and how it is likely to change in the absence of the project, estimating how their income is likely to change *with* the project, and finally comparing the two flows of income by calculating the ERR.

The following provides further details on each of these four steps:

I. Define the intended beneficiaries and the set of actions that are necessary and sufficient to achieve the projected increase in incomes.

- A. One should begin by specifying the expected scope of the project's benefits, determining who is likely to benefit from the project. MCC considers beneficiaries of projects to be *those people who experience better standards of living as a result of the project through higher real incomes*. These beneficiaries include owners and employees of firms whose value-added is expected to increase due to the project.
- B. MCC has found it useful to classify projects according to their scope to help predict the number and type of beneficiaries for different projects. MCC uses the following categories:
 - *National or Regional Investments* are large-scale infrastructure projects that are expected to affect broad geographical areas of an economy, making *all* citizens in these areas beneficiaries.
 - *Broad-Based Investments* are other large-scale investments whose beneficiaries are typically counted as users of the new or improved public systems or those who will benefit from the use by others.
 - *Targeted Projects* include all other activities that benefit specific individuals and households, such as projects that focus on agricultural development, school construction or other educational development efforts.
- C. MCC policy is to obtain household survey data for assistance in quantifying the impact on beneficiaries as soon as possible. Such information is essential to understand who is likely to benefit from the activity and what the magnitude of the benefit is likely to be for these individuals.
- D. The impact on incomes of each intervention should be considered separately. Only when there is solid evidence of strong complementarities among the returns to these activities can multiple activities be combined into one model. For example, agriculture projects often are composed of a number of separate activities (e.g., technical assistance to farmers, rural roads, cold storage). Each activity should be considered separately to determine whether the specific activity generates sufficient impact to justify its costs. Although program designers sometimes suggest that a set of activities are jointly necessary to boost exports and incomes of households, this assertion that each and every component is truly necessary needs to be critically assessed.
- E. Projects must have a strong rationale for public sector involvement, such as the provision of public or quasi-public goods or services or the presence of important market failures (e.g., demonstrable information asymmetries or coordination problems, supported by evidence).⁸ When the gains from a project are large and concentrated among relatively few actors, the analysis should examine why such actors cannot undertake the investment without MCC funds. The ERR model for the proposed project must either explicitly incorporate an analysis of the incentives of these individual actors or be accompanied by an explanation of the rationale for public sector involvement that includes documented evidence.

II. Gather data on *current* incomes or total value-added of the intended beneficiaries and estimate how these are likely to change *without* the project over time.

- A. The assessment of what will happen *without* the program should estimate what will *most likely* occur, not what is desired or what will occur under the best circumstances. When estimating what will happen in the absence of the program, the standard assumption should be that recent past practices will prevail. If production trends have been trending upwards, the without-program scenario should reflect this rising baseline rather than a no-growth assumption.
- B. MCC's standard practice is to study projects over a 20-year time horizon. When there is

strong evidence that the useful life of the MCC investment is shorter or longer than 20 years, such adjustments to the time horizon should be made, but noted explicitly and explained in the accompanying text. In all cases, analysts need to study the sustainability of investments over such time periods, including the probability that necessary maintenance will be completed. The analysis may vary the time period over which the ERR is calculated to determine the sensitivity of the estimated returns to the time horizon. When the magnitude of the economic returns is sensitive to the time horizon, this should be noted explicitly, as well.

- C. The analysis may estimate benefits as value-added or incomes. GDP can be measured in several ways: by summing value-added over all enterprises in the economy, or by summing incomes over all legal entities (e.g., wages or labor income of households, profits). Both methods are equally valid. For agriculture projects, country and MCC analysts may find it convenient to work with household incomes as the unit of analysis; for other projects, value-added of groups of enterprises or of a region of the country may be more convenient.

III. Estimate how incomes or total value-added of firms will increase *with* the project over the same time horizon.

- A. The primary goal of this step is to identify the economic logic through which the project activities lead to higher incomes or value-added and estimating the magnitude of this effect using reasonable estimates from country-specific data or other experiences in other relevant, comparable contexts.
- B. In keeping with the focus on economic growth, and in recognition that data are often scarce in MCC countries, economic analysis should focus on forecasting increases in incomes or value-added from projects and exclude consumer surpluses or other economic rents.⁹
- C. When the project relies on individuals or firms making decisions, such as investing, changing economic behavior, or participating in a publicly funded program, a financial analysis should be performed from the perspective of these actors to confirm that they have a financial incentive to perform those actions, with proper accounting of their opportunity costs. For example, when a project upgrading an irrigation system relies on farmers cooperatively maintaining newly purchased equipment, the analysis should explicitly consider what an individual farmer's income is likely to be if he or she invests in maintenance and what will happen to the project if those investments do not take place.
- D. Projects should not be undertaken if the positive economic benefit hinges on the presence of a tax or subsidy. Therefore, economic analysis should use shadow prices whenever possible. Shadow prices are the market prices that would prevail in the absence of taxes, subsidies or administrative restrictions on market activity.
- E. Demand multipliers (additional effects beyond project-generated increases in income that can be directly estimated) generally should not be used in ERR analysis, unless: (a) the region of the project has significant excess capacity; and (b) there is prior empirical evidence that these effects are significant. MCC will seek to gather its own evidence on the magnitude of demand multipliers for use in future estimates of the economic returns. MCC is aware that most guidelines on cost-benefit analysis recommend approaching claims of large multipliers critically, and is wary of projects whose economic rationale relies on the assumption of large unidentifiable benefits.

IV. Construct a cash-flow analysis and estimate the ERR

- A. A cash-flow analysis should be compiled in a spreadsheet, in which the project costs over time are negative entries and the net incomes or value-added (i.e., the difference between II and III, above) represent the projected benefits. These should be laid out on a year-by-year basis for the project's time horizon, normally 20 years (as detailed above).

- B. When calculating the costs of using productive resources, such as labor, land and capital, such resources should be expected to be used in their best alternative activity. In other words, the concept of opportunity costs should be used in evaluating the costs of using resources.¹⁰ For example, when analyzing a project that creates new jobs in the economy, it is usually incorrect to assume that the individuals who will be employed in these jobs would otherwise have been earning no income. Instead, the opportunity cost of labor should be estimated, usually as a weighted average of the wage rates in the formal and informal sectors, adjusted by the overall unemployment rate. The wage benefit from the new jobs can be estimated as the difference between the wages paid and the opportunity cost of labor.
- C. Important environmental and social benefits, costs, and risks of projects should be listed and quantified where possible.
- D. The analysis should look at growth in *real* incomes adjusted for expected inflation. Both costs and benefits should be expressed in terms of either local currency or U.S. dollars in the same base year (e.g., “2009 dollars”).
- E. Once all of the year-by-year costs and benefits have been incorporated, the ERR can be calculated as a single summary statistic over the project’s time horizon. Again, the ERR is the discount rate at which the discounted benefits equal the discounted costs.
- F. Sensitivity analysis should also be conducted, using variance decomposition or other tools to identify the key parameters driving the returns. The analysis should also focus on those parameters or assumptions for which the evidence is weakest and those which have the largest impact on ERR point estimates.
- G. The spreadsheet should be accompanied by a text document that explains the underlying economic rationale for the project, addresses each of the key points mentioned above, and provides any supporting evidence, such as citations of studies in which the key parameters used in the ERR calculation had been estimated.

Minimum Standards for ERRs

MCC recognizes that the assumptions involved in any ERR analysis introduce a considerable degree of uncertainty and, as noted above, that *ex ante* expectations may not be matched by *ex post* observations. MCC is aware that other donors have hurdle rates for many of their projects, and has reviewed the reported experience of others, as well as the *ex ante* expectations for the programs and projects it has financed to date. MCC has an active interest in both attracting private sector investment and coordinating with other donors, and seeks to avoid “crowding out” other sources of funding.

MCC uses a standard hurdle rate of 10 %, which is similar to hurdle rates of other donors.¹¹ In rare instances, MCC reserves the discretion to proceed with projects that fall below the minimum acceptable ERR. Thorough justification would be required, based on the unique circumstances of any such proposed case for the application of this discretion, but it is expected that country partners share the understanding that MCC funds are to be viewed as investments of public funds that must earn a minimum return for the country’s citizens.

Guidance on Conducting Beneficiary Analysis (BA)

In proposing projects for MCC funding, partner countries should develop a Beneficiary Analysis (BA) that

describes the expected project impact on the poor and other important demographic groups. The BA should answer three basic inter-related questions:

Beneficiaries: How many people are expected to benefit from increased household incomes as a result of the project, and what proportion of them is poor?

The Magnitude of Benefits: How much, on average, will each individual beneficiary gain from the project?

Cost Effectiveness: For each dollar of MCC funds invested, how much will be gained by the poor?

This BA should reflect the outcome of an iterative project design process that incorporates considerations of impact and distribution. Ultimately, both the total amount of benefits (reflected in the ERR) and the distribution of those benefits (reflected in the BA) are crucial elements of MCC's economic analysis. A Beneficiary Analysis example is shown in Table 4, Annex 2.

Terminology

Classifying beneficiaries as poor or non-poor requires first defining beneficiaries and poverty. As stated earlier, *MCC considers beneficiaries of projects to be those people who experience better standards of living as a result of the project through higher real incomes.* These beneficiaries include owners and employees of firms whose value-added is expected to increase due to the project. Some projects may affect large numbers of people, but only a portion of these individuals will realize higher incomes or lower expenditures. For example, a training program may have many participants, but only some of these will adopt new practices and experience higher incomes. The BA should focus on beneficiaries who realize income gains or expenditure savings, but can also include a separate discussion and tabulation of other individuals who realize only non-monetary benefits.

Consistent with standard poverty measurement practices, MCC considers the household the most practical unit of measurement, which reflects the underlying assumption that when one household member earns additional income, all household members benefit. As such, *MCC defines and counts as beneficiaries all members of households that have at least one individual who realizes income gains.*¹²

In defining poverty, MCC generally uses the following poverty lines to classify beneficiaries:

Poverty Category	Per capita daily consumption (PPP adjusted) ¹³
"Extremely Poor"	
"Poor" ¹⁴	
"Near Poor"	\$2.00 – \$4.00
"Not Poor"	> \$4.00

Most countries can be expected to have official poverty lines that differ from these international lines. The

BA may consider the distributional implications using national lines, but such calculations should be used in addition to (not instead of) the income categories described above.

Counting Beneficiaries

As detailed on page 40, MCC has found it useful to classify projects according to their scope to help predict the number and type of beneficiaries for different projects. MCC uses the following categories:

- *National or Regional Investments* are large-scale infrastructure projects that are expected to affect broad geographical areas of an economy, making *all* citizens in these areas beneficiaries.
- *Broad-Based Investments* are other large-scale investments whose beneficiaries are typically counted as users of the new or improved public systems or those who will benefit from the use by others.
- *Targeted Projects* include all other activities that benefit specific individuals and households, such as projects that focus on agricultural development, school construction or other educational development efforts. For such projects, MCC counts as beneficiaries all members of those households that experience higher incomes.

For many projects, the project development process will produce information on the population of likely beneficiaries, including administrative data from existing public or private systems, such as school enrollments, agricultural extension records, and water authority customer accounts. Together with the designed capacity of a project, such data may suggest the number of individuals who are expected to “receive treatment” through the program.

In some cases, the project design and budget will not limit participation to a fixed number of individuals, nor will administrative or other data provide an adequate estimate of the actual number of individuals expected to receive treatment from a project (e.g., road projects). Upgrading a section of highway does not in itself limit the number of vehicles travelling on the road. Vehicle counts combined with the HDM-IV model may allow a reasonably accurate estimate of the number of vehicles expected to travel on the improved road. However, road projects are expected to benefit a wider set of individuals beyond those travelling on the roads themselves; as such, all households living within a certain distance of the improved roads are likely to benefit. Where available, a recent census or other survey dataset may therefore be useful in estimating the number of individuals who will benefit from a project.

Estimating the Incidence of Benefits for National/Regional and Broad-Based Investments

After estimating the total number of beneficiaries, the BA should assess the share of beneficiaries by income category. The best approach is to use survey results to determine current participation in similar activities or the likelihood that particular individuals might benefit from broad-based initiatives.¹⁵ The Preliminary BA need not involve first-hand analysis of these data, but should be based on reports and existing evidence derived from them. When these are not available, other sources may be used to estimate the participation of the poor in the project.

The benefits that each individual is expected to receive from the project should be driven in part by the

ERR model, which calculates the total benefits accruing to all segments of society. MCC expects that most national or regional investments, such as primary roads, may have significant but diffuse effects on household incomes throughout the relevant geographic area (these investments are either national or regional in scope). Because such investments do not generally alter the “rules of the game” that drive distributional outcomes, the BA should presume that additional income generated by these investments will be distributed consistent with the existing pattern of household incomes within the relevant geographic boundaries of beneficiaries.¹⁶

For MCC investments in public services, such as water and sanitation infrastructure, the analysis might begin with data reflecting the composition of existing users of this infrastructure. These numbers might then be adjusted to reflect any information that would suggest that the poor are more or less likely to use newly built, expanded or upgraded infrastructure.

Estimating the Incidence of Benefits for Targeted Projects

For targeted projects, the existing participation of the poor in similar activities can often be used to predict the likely profile of participants in MCC programs. Consider the example of a Vocational Education project that will improve the quality of education at technical schools located in the major cities and will offer new scholarships for low-income students. The composition of existing graduates of vocational education in the country’s urban areas might be used to describe the expected profile of new students, with an adjustment for the number of additional poor students that will participate as a result of scholarships.

The share of benefits accruing to the poor can vary based on both the participation rates of the poor and the magnitude of the benefits relative to one’s initial poverty level. For example, a vocational education program may yield a 10 percent gain in annual income for graduates of the program; even if poorer students are expected to realize higher than average gains in percentage terms, they might still experience smaller absolute gains. The incremental changes in income for beneficiaries at different levels need to be realistic and consistent with results produced by similar activities in other contexts.

Disaggregation by Important Demographic Categories

The BA is designed to focus largely on a proposed project’s impact on the poor, consistent with MCC’s stated mission to reduce poverty through economic growth. Although national and broad-based investments are not expected to substantially alter the distribution of income both across and within households, targeted program interventions are more likely to differ significantly in the distribution of benefits across other important demographic categories. Gender is discussed as a special case, followed by a more general consideration.

Disaggregation by Gender

MCC’s Gender Policy requires that gender considerations are integrated into the development and design of programs, the assessment and implementation of projects, the monitoring of program results, and the evaluation of program impacts. The BA should include an explicit discussion of the extent to which

gender differences are expected to arise in the likely distribution of benefits from each project. Such analyses, however, often require intra-household consumption data that are not available and are difficult and expensive to acquire. Given finite resources and practical realities, this guidance seeks to establish a framework for identifying the highest priorities for gender-disaggregated beneficiary analyses.

Gender-disaggregated beneficiary analysis should follow these guidelines:

- Consider the expected pattern of program participation or use of improved services by sex. When programs appear to exclude women in participation or use, concerns are merited, and some formal consideration of the possible intra-household dynamics is warranted.
- Investigate whether intra-household dynamics are likely to result in adverse impacts of a project on women, children, or disadvantaged groups.

Where this analysis or other evidence collected during due diligence raises serious concerns regarding an activity's adverse impact on the welfare of either men or women, these should be addressed as a normal part of MCC's pre-investment assessment and would be resolved through modifications of the program design. For targeted projects, analysis should always consider possible gender differences in the use of services affected by the project, and compare participation or use among men and women relative to their proportion in the relevant population. Not all projects need to have equal participation by men and women (indeed, some project designs offer compelling reasons for exclusively targeting one sex, such as health programs directed at pregnant or lactating women), but every project must include an explicit consideration of participation and the incidence of benefits by sex.

Disaggregation by Other Characteristics

Projects may also vary in their effects across other demographic and geographic groupings, such as education level, ethnicity, household size and type (e.g., single-female head, elderly head, two-parent head), and region (rural or urban). The BA should identify where such differences are expected to arise and whether their magnitudes are expected to be significant. In particular, when project effects vary widely across such groups, the analysis should note these differences, explain their sources, and note any project design elements that have been included to address these differences.

Partner Country Responsibility

The MCA-eligible country has the primary responsibility for quantifying the economic rates of return, conducting a beneficiary analysis, and incorporating expected incremental changes in beneficiary incomes as targets within an M&E plan. Net improvements in income levels and participation and benefit incidence by poverty category should be estimated based on the anticipated outputs and outcomes of individual program projects. Participation rates tabulated by gender and other important characteristics should also be estimated.

MCC Responsibility

Following the submission of the country concept papers, MCC will review these estimates of economic rates of return and beneficiary analysis. In the course of this process, the MCC will work with partner

countries to help identify and assess possible alternatives to proposed projects, including modifications or complements that would enhance the program's impacts on growth and poverty reduction. MCC may also refine ERRs based on new evidence, including that generated by relevant MCC experience elsewhere, and may supplement the BA using further analysis of the survey datasets highlighted by the partner country.

Annex 1

This section provides examples of economic rate of return analyses for health and education projects, showing how the cash-flow analysis could be organized for such programs.¹⁷

The first example is an education program in Mexico that offered cash assistance to poor families in exchange for higher school attendance.¹⁸ Payments were offered to families that kept their children in schools. These payments depended on the age and gender of the child, with higher payments for high school children and higher payments for girls. A study of this program, described in Morley and Coady (2003, p. 72), estimated that the program spent about 8,200 pesos per child to increase annual income by approximately 1000 pesos. Since the working life of a child is longer than the period over which payments are given, this program could be justified economically.

To see this, we have summarized the economic case for this program in a cash flow analysis in Table 1. As can be seen in the cost per child row of the table, the program would spend 787 pesos per child when children were 9 years old, 898 the next year and further amounts in subsequent years. The net cash transfer to the family in the first two years would be 669 pesos and 763 pesos (after deducting 15 percent for administrative costs). These administrative costs can vary substantially, so specific attention should be paid to their accurate estimation.¹⁹ Drawing on rigorous evaluations of the impact of this program on educational attainment, studies have shown that this amount of spending is sufficient to raise the education attainment by two-thirds of a year by the time the child enters the labor force. Drawing further on studies on the returns to education in Mexico, Morley and Coady (2003) estimate that this will raise earnings by approximately 1,000 pesos per year over the working lifetime. In Table 1, we have shown the additional income of the child during the first three years of working life, corresponding to ages 16-18. The rest of the table, covering the rest of the working life, is not shown to save space.

The benefits of this program include the 1,000 pesos per year in additional incomes plus the net cash transfers to the families. The costs are of course the annual costs of the program. Table 1 shows that such a program would have an economic rate of return of 20 percent over ten years and 33 percent over 20 years. While each of the specific numbers in this table could be refined, the table establishes the basic point that this kind of education program can achieve positive economic returns. Again, this table is only illustrative. Similar CCT programs could yield unacceptably low ERRs if their administrative costs are substantially higher or if their effectiveness at improving enrollments rates is lower, and these variables are highly context specific. Moreover, an increasing number of studies devoted to CCTs suggest that impacts on longer-term educational outcomes, such as performance on educational tests, may be more moderate than those on enrollments.²⁰

The second example is a health program to address iron deficiency. Recent studies have shown evidence that Iron Deficient Anemia (IDA) is associated with greater susceptibility to disease, and contributes to reduced aerobic capacity and endurance.²¹ Health programs in China and Vietnam added iron supplements to sauces that are common in the diet. Further studies suggest that economic output and incomes can be raised significantly by supplementing diets in this way.

To provide an example of how to calculate the ERR for such programs, we rely on a recent rigorous study

that suggested that incomes could be raised by an average of \$40 per person per year by providing supplements that cost an average of \$6 per person. Only a fraction of the people in any community is iron deficient, but because it is expensive to identify them and because it is hard to change the behavior of only selected populations furthermore, the most cost-effective strategy is often to treat the entire community.

To show a concrete example, consider Table 2, and imagine that there are 20,000 persons in a community and that 30 percent of them are iron-deficient. For these people, income will be raised by \$40 with the dietary supplement program, but the health of the other 70 percent will be unaffected. Assume further that it will take seven years for the full productivity and health impact of the program to take effect. The cost of the program would be \$120,000 per year for seven years (treating all 20,000 at \$6 per person). As for the benefits (in the form of a rise in incomes), by year 7, 30 percent of the 20,000 will obtain an additional \$40 in income for a total benefit of \$240,000. For the early years before year 7, it is assumed that 1/7 of these benefits will be realized in the first year, 2/7 in the second year and so forth. It is assumed that iron supplements must be provided every year.

Table 2 shows that net benefits for this program turn positive as early as year 4, and have an ERR of 34 percent over 10 years. The ERR over 20 years is 40 percent. These returns are sensitive to the fraction of the population that is iron deficient. If this fraction were 40 percent rather than 30 percent, the ERR would rise to 59 and 62 percent.

The third example is from a combined health and education project that offered de-worming drug treatment to children in Kenya.²² Rigorous evaluations indicated that this program increased school attendance by approximately 0.15 years for every year a child was treated. Further research by Knight and Sabot (1990) suggests that an additional year of schooling generates a rate of return of approximately 7 percent in terms of individual wages in future years.

The best way to calculate the economic returns of such a program would be to collect information on earnings of adults in the area under consideration. Short of this, however, we can still show some approximate figures. GDP per worker in Kenya is \$570. If 60 percent of this is wages and rural wages are 80 percent of the national average, an estimate of the rural adult wage would be \$273.6.

The de-worming treatment costs 49 cents per child per year. In Table 3, we have shown an example where such treatment is offered to a child every year in school between age 7 and 14. Using the 0.15 figure above, these eight years of treatment would mean that the child would gain the equivalent of slightly more than a year of education by age 14 when he or she enters the labor market (0.15 times eight years of treatment equals 1.2 years of education). Using the estimated seven percent figure for the returns to education, this would translate into an additional \$22.33 in earnings by the time the child becomes a fully productive working adult (assumed here to happen by age 20). Before age 20 we have assumed that the child would earn only part of this premium.

Altogether this program would have an economic rate of return of 46 percent. This high return is driven by the fact that at 49 cents per child, the cost of the program is low relative to the additional earnings that a child could earn from additional school attendance. Of course, all of these estimates could be investigated further and refined. To achieve such a low cost per child, the program may have to be

administered on a large scale. But with a large increase in the supply of educated children, the return to education might well be lower than estimated here.

These examples are given, not to recommend specific programs, but rather to illustrate how ERR calculations could be done for health and education programs and to establish that the ERR framework is not biased against social investments like health and education projects.

Table 1: Conditional Cash Transfer for Education Program

Year	1	2	3	4	5	6	7	8		20
Age of Child	9	10	11	12	13	14	15	16		28
Cost per Child	-787	-898	-1,154	-947	-1,380	-1,446	-1,563			
Administrative costs per Child	118	135	173	142	207	217	234			
Cash Transfer to Child's Family	669	763	981	805	1,173	1,229	1,329			
Additional Earnings from Increased Education								1,000		1,000
Benefits	669	763	981	805	1,173	1,229	1,329	1000		1,000
Costs	-787	-898	-1,154	-947	-1,380	-1,446	-1,563	0		0
Net Cash Flow	-118	-135	-173	-142	-207	-217	-234	1,000		1,000
Economic Rate of Return (10 years)	20%									
Economic Rate of Return (20 years)	33%									

Table 2: Iron Deficiency Program

Population	20,000									
Cost per person of Iron Supplements	\$6									
Percent of the population deficient	30%									
Increase in income from reduction in iron deficiency	\$40									
Years to reach maximum	7									
Year	1	2	3	4	5	6	7	8	9	10
Cost	\$120,000	\$120,000	\$120,000	\$120,000	\$120,000	\$120,000	\$120,000			
Increase in incomes	\$34,286	\$68,571	\$102,857	\$137,143	\$171,429	\$205,714	\$240,000	\$240,000	\$240,000	\$240,000
Net Cash flow	-\$85,714	-\$51,429	-\$17,143	\$17,143	\$51,429	\$85,714	\$120,000	\$240,000	\$240,000	\$240,000
ERR (10 years)	34%									
ERR (20 years)	40%									

Table 3: De-worming Program

Output per worker (in USD)	\$570.00															
Share of Output per Worker Attributable to Wages	0.6															
Rural Wage discount (compared to average wage)	0.8															
Increase in years of schooling for each year of de-worming	0.15															
Estimated Rate of Return to Each Year of Education	0.07															
Annual cost of de-worming per child	\$0.49															
Year		1	2	3	4	5	6	7	8	9	10	11	...	20		
Age		7	8	9	10	11	12	13	14	15	16	17	...			
Age-wage Profile (in percent of adult wage)										0.5	0.6	0.7	...	1		
School Year		1	2	3	4	5	6	7	8					1		
Work Year										1	2	3	...	26		
Estimated adult wage in rural area	\$273.60					Wages without Program						\$136.80	\$164.16	\$191.52	...	\$246.24
Estimated additional earnings due to additional years of education	\$22.33					Wages with Program						\$139.99	\$170.54	\$201.09	...	\$262.19

														\$273.60
Net cash flow		-\$0.49	-\$0.49	-\$0.49	-\$0.49	-\$0.49	-\$0.49	-\$0.49	-\$0.49	\$3.19	\$6.38	\$9.57	...	\$22.33
ERR (20 years)	46%													

Annex 2, Table 4: Preliminary Beneficiary Analysis example

Hypothetical Farmer Training Program

This hypothetical farmer training program involves an investment of \$20 million focused on raising profits per hectare among trained farmers by 10%. Ten thousand farmers are expected to enroll in the training program; 80% of these trainees are expected to eventually adopt the improved farming practices. Each of the farmers adopting the improved practices is likely to gain \$2,851 over the ensuing 20 years. The gains will be shared by the other members in the households of these farmers, providing an average of \$570 to these 40,000 beneficiaries.

Fifty percent of the farmers in the program are considered “poor” (of which one fifth are “extremely poor”), while 25% are “near-poor” and 25% are “not poor.” Farmers apply the practices in which they are trained across their plots. Because poor farmers typically have smaller farms, they are likely to realize fewer benefits from the training. Such a program may still yield sufficient average benefits across the array of trainees to justify its cost; nonetheless, poor farmers will only realize \$0.16 of benefits for every dollar invested in the program.

Hypothetical Farmer Training Program

Program Details					
Total Cost	\$20 mil.				
Number of farmers trained	10,000				
% of trainees adopting trained practices	80%				
Number of farmers adopting trained practices	8,000				
Average household size	5				
Total beneficiaries	40,000				

Poverty Distribution of Trainees					
% of trainees, extremely poor	10%				
% of trainees, poor	50%				
% of trainees, near poor	25%				
% of trainees, not poor	25%				
Costs and Benefits per Farmer					
Training costs	\$ 2,000				
Benefits					
Initial annual profit per hectare	\$ 1,000				
Increase in profit per hectare (%)	10%				
Average farm size, extremely poor (ha)	0.5				
Average farm size, poor (ha)	1				

Average farm size, near poor (ha)	2				
Average farm size, not poor (ha)	10				
Year	1	2	3	...	20
Benefits, extremely poor		\$ 48	\$ 48	\$ 48	\$ 48
Benefits, poor		\$ 96	\$ 96	\$ 96	\$ 96
Benefits, near poor		\$ 192	\$ 192	\$ 192	\$ 192
Benefits, not poor		\$ 960	\$ 960	\$ 960	\$ 960
Average Benefits		\$ 336	\$ 336	\$ 336	\$ 336
Average Net Benefits	\$ (2,000)	\$ 336	\$ 336	\$ 336	\$ 336
ERR	16%				
Total Costs and Benefits					
Present Value of Total Project Benefits					
PV of Benefits, extremely poor	\$321,213				

PV of Benefits, poor	\$3,212,129				
PV of Benefits, near poor	\$3,212,129				
PV of Benefits, not poor	\$16,060,647				
Present Value of Total Project Benefits Per Beneficiary					
PV of Benefits / Farmer Adopting Practices	\$ 2,851				
PV of Benefits / Beneficiary	\$ 570				
PV of Benefits / Beneficiary, extremely poor	\$80				
PV of Benefits / Beneficiary, poor	\$161				
PV of Benefits / Beneficiary, near poor	\$321				
PV of Benefits / Beneficiary, not poor	\$1,606				

Cost Effectiveness: Project Benefits / Total Cost					
Total Project Benefits / Total Cost	\$1.12				
Project Benefits / Total Cost, extremely poor	\$0.02				
Project Benefits / Total Cost, poor	\$0.16				
Project Benefits / Total Cost, near poor	\$0.16				
Project Benefits / Total Cost, not poor	\$0.80				
Participation Rates by Gender					
% of trainees who are female	25%				
% of trainees, female-headed households	20%				

% of farming households in the region headed by women	15%				
Average farm size, female-headed households (ha)	1				

Environmental and Social Assessment of Projects Proposed During Compact Development

MCC recognizes that sustainable economic growth depends on healthy people and healthy environments. Development that does not adequately address environmental and social risks can leave the poor vulnerable and leave society with fewer options for the future. Conversely, sound environmental and social management contributes to equitable and sustainable development. Broad stakeholder engagement and participation throughout compact development is a critical element for the preparation of a successful compact proposal.

Environmental & social standards

MCC compacts should be environmentally and socially sound and designed in compliance with applicable eligible country laws, regulations and standards, as well as international agreements by which the eligible country is bound. MCC's expectations and requirements for the environmental and social performance of the programs it supports are outlined below:

- *MCC's Enabling Legislation.* Sec. 605(e)(3) of the Millennium Challenge Act of 2003 prohibits MCC funds from being used to support any compact activity that is "likely to cause a significant environmental, health, or safety hazard." MCC's Environmental Guidelines (see below) further elaborate on this prohibition: a project is deemed "likely to cause a significant environmental, health, or safety hazard" if "as a result of the project, even with mitigation efforts and proper use, there exists or will exist a substance, condition, or circumstance that represents a significant risk of harm to the environment or to human health because of the physical, chemical or biological effects of such substance, condition or circumstance."
- *MCC Environmental Guidelines.* MCC's [Environmental Guidelines](#) describe the principles of environmental and social impact assessment that compact-eligible countries will be expected to apply; the Guidelines also establish a process for assessing potential environmental and social risks and opportunities. This process is designed to ensure that the level of environmental and social analysis and review is commensurate with the risks and opportunities of each project. The process also helps to ensure that MCC-supported projects meet applicable laws and regulations (including those of the eligible country), are not likely to cause a significant environmental, health or safety hazard, and integrate environmental and social considerations into project design and implementation, thereby improving performance and sustainability. Further, the Environmental Guidelines require compact-funded activities to be developed and implemented in a manner consistent with the *Performance Standards on Environmental and Social Sustainability* of the International Finance Corporation (IFC Performance Standards).
- *Performance Standards.* MCC adopted the International Finance Corporation's (IFC) [Performance Standards on Environmental and Social Sustainability](#) in June 2012. The Performance Standards are an internationally-accepted framework for managing the environmental and social risks of development projects and are a key part of MCC's approach to risk management and how MCC puts the Environmental Guidelines into practice at an operational level. The Environmental Guidelines describe MCC's *process* for categorizing projects and assessing environmental and social risks. The Performance Standards complement the Environmental Guidelines by specifying

the required *standard* of environmental and social performance compact-funded activities are expected to meet.

The Performance Standards help MCC and its partner countries manage and improve compact environmental and social performance through an approach that is systematic, outcomes-oriented, and commensurate with the level of project risks and impacts.Â By helping to manage environmental and social risks and opportunities, they contribute to larger and more sustainable development benefits.

There are eight Performance Standards (PS):

- PS1 – Assessment and Management of Environmental and Social Risks and Impacts
- PS2 – Labor and Working Conditions
- PS3 – Resource Efficiency and Pollution Prevention
- PS4 – Community Health, Safety, and Security
- PS5 – Land Acquisition and Involuntary Resettlement
- PS6 – Biodiversity Conservation and Sustainable Management of Living Natural Resources
- PS7 – Indigenous Peoples
- PS8 – Cultural Heritage

IFC provides a set of eight [Guidance Notes](#) that correspond to each Performance Standard. While MCC has not adopted the Guidance Notes as official policy, they provide useful information and guidance on the requirements contained in the Performance Standards and on good sustainability practices that will help MCC's partner countries meet the Performance Standards and improve project performance. MCC has prepared a *Performance Standards Implementation Note* that provides additional guidance on how MCC expects its partner countries to put the Performance Standards into practice. The Implementation Note will be updated from time to time as needed to reflect MCC's experience and lessons learned through its use of the Performance Standards.

Operational aspects

Given the importance of incorporating analysis of environmental and social risks and opportunities from the outset of Compact Development, MCC requires that the Compact Development Team include an Environmental and Social Performance Director (ESPD). The Director's role is important and requires a seasoned professional who understands the country's environmental, resettlement, health and safety regulations and requirements, has experience conducting or reviewing environmental and social impact assessments (ESIAs) and Resettlement Action Plans (RAPs), and can work with the country Compact Development Team to ensure that environmental and social considerations are appropriately integrated into the identification and design of the compact proposal. MCC also requires that the core team include a social scientist with gender expertise who will work with the ESPD.

MCC's Environment and Social Performance (ESP) staff collaborate closely with counterparts on the Compact Development Team. The shared objective is to promote sound environmental and social performance throughout all stages of compact development and implementation. MCC's ESP staff will also engage outside technical experts to assist in the review of project concepts, feasibility studies, and designs. While the completion of the requisite environmental and social analyses (e.g. environmental and

social impact assessments, resettlement action plans, health and safety plans, etc.) is the responsibility of the eligible country, MCC's ESP staff will work closely with the country Compact Development Team to identify and manage environmental and social risks and enhance project opportunities and outcomes.

General Infrastructure Guidance

The following guidance applies to all infrastructure projects, regardless of sub-sector or type of project and should be considered as general guidance. The guidance is intended to cover all aspects of a complex project in a comprehensive manner.

In accordance with MCC's compact development process, an early assessment of an eligible country's concept paper shall be made to determine whether the projects contained in the concept paper qualify for project development or appraisal, should be dropped from further consideration by MCC, or should be modified and developed further prior to appraisal. This assessment is primarily focused on: (i) **justification** of the proposed project, i.e., whether the proposed project has sufficient characteristics to be able to contribute to poverty reduction through economic growth; (ii) whether the proposed project is **sufficiently well developed**, and if so, whether MCC recommends that appraisal could commence; (iii) an early indication that the project is **technically viable**; (iv) an early indication that the project **can be implemented within the compact term** (maximum of 5 years); and (v) an early indication that the project benefits **can be sustained over time**. Moreover, the concept paper assessment will also make a determination on: (a) whether mitigation measures required to improve the project's sustainability or reduce project risks are formidable; and (b) whether fundamental policy and regulatory environments relating to the project or applicable sector are acceptable to MCC, and if not, whether meaningful changes can be made within the compact development or compact implementation time frame. Typically, MCC would not recommend that appraisal or project development be continued if any of these factors are found to be unsatisfactory.

For most infrastructure projects, MCC requires a comprehensive, recent (i.e., not older than 5 years) feasibility study of acceptable quality to commence appraisal. A generic table of contents for a feasibility study should include the following:

1. Detailed Project Description
2. Policy and Regulatory Environment and Issues; Conformance with Sector Strategy
3. Analysis of Site Conditions
4. Special Studies (such as topographic, geological, geotechnical, hydrological, structural, as may be appropriate for the particular project)
5. Project Justification
6. Project Design and Project Alternatives
7. Comprehensive Project Costs and Schedule
8. Beneficiary and Economic Analysis
9. Environmental and Social Impact Assessment
10. Financial Sustainability
11. Operations and Management (O&M)
12. Institutional Capacity and Capability
13. Implementation Management and Construction Schedule
14. Construction Resources
15. Pre-Construction Activities

MCC will use the feasibility study as the basis to make a determination on what supplemental studies, if

any, are required to develop the project sufficiently so that appraisal could commence. **Once MCC has made the determination to commence appraisal, the MCC infrastructure group will conduct the assessments and identify any key constraints.**

The remainder of the guidance is provided for each major project type due to differences in requirements.

Guidelines for Countries Proposing Private Sector Development Projects

This document is intended to provide an overview of the way MCC conducts due diligence on private sector development activities.

Introduction

The due diligence process entails a rigorous analysis of the compact proposal received from an eligible country for the purpose of determining whether that proposal meets MCC criteria for funding. This document describes how that analysis is expected to be executed for Private Sector Development (PSD) components within compact proposals. It also provides best practice guidelines for due diligence of initiatives involving access to credit (specifically, on-lending) and legal and regulatory reform.

The first section (Objective and Approach) provides a brief overview of the objective of due diligence and the approach used by MCC. The second section (Due Diligence Requirements) contains questions which should guide the due diligence process for all PSD proposals. The third section (PSD Best Practice Guidelines) contains: (i) a set of general guidelines which PSD will use in assessing proposals, and (ii) standards and best practices to be used in assessing specific PSD initiatives such as access- to-credit and legal and regulatory reform. The objective of the PSD methodology is to ensure that the final compact proposals incorporating PSD will be as well-designed as possible.

Objective and Approach

The purpose of the due diligence process is to allow MCC to make an informed decision as to whether the proposed initiative is compliant with MCC guidelines, is likely to achieve the intended outcomes, and is designed in a manner which will achieve maximum results.

The PSD group undertakes due diligence through a three step process:

- Assessing whether the proposed initiative is compliant with MCC requirements.
- Assessing the initiative as proposed in regard to the likelihood of its accomplishing the stated developmental challenge.
- Assessing whether the initiative is compliant with best practice guidelines.

PSD considers due diligence to be a critical part of the compact development process. Due diligence provides an opportunity for collaboration with core team counterparts to identify and reduce risks, strengthen proposed initiatives, ensure integration and linkages with other compact initiatives, and refine budgets and timelines. Due diligence also provides the basis for establishing any conditions precedent to be included in the legal agreements.

The due diligence process will culminate in a recommendation to either: (i) approve the initiative as-is; (ii) approve the initiative on a conditional basis (assuming certain changes); or (iii) disapprove the initiative.

MCC Due Diligence Requirements

Due diligence will commence when MCC has received a complete proposal from the core team. A complete proposal is one which includes an outline of the development challenge, the proposed initiatives which address the development challenge, the proposed budget for those initiatives, and an economic rate of return analysis.

Due diligence will be complete when PSD has reached a conclusion as to whether the initiative as finally proposed (following assessment of the proposal as-is and full exploration of how the proposal can be strengthened) is compliant with MCC requirements, is likely to achieve its objectives, and comports with PSD best practice guidelines.

In order to make this determination, PSD will assess the proposal according to the following two sets of questions (which incorporate and expand upon MCC's Due Diligence Checklist).

Does the initiative comply with MCC requirements?

Economic Growth and Poverty Reduction

- Does the initiative show a clear and compelling link between economic growth and poverty alleviation?
- Does the projected economic rate of return meet MCC requirements?
- Is the projected economic rate of return based on logical and defensible logic?

Sustainability

- Will the proposed initiative be sustainable (capable of continuation without third party support) following compact close?
- If not, is there an acceptable rationale which would justify the initiative?
- Does the initiative rely unnecessarily on subsidies or other forms of intervention which are unacceptable to MCC?
- If so, is there an acceptable rationale for undertaking the initiative on that basis?
- Will the initiative result in a market distortion?
- If so, is there an acceptable rationale?

Social and Environmental

- Does the proposed initiative impair gender equality? Does it help strengthen gender equality?
- Does the proposed initiative violate environmental responsibility?
- Is the supply of skilled human resources sufficient to build and sustain the innovation? If not, how should this be addressed?

Fiscal Accountability

- Are the procedures for the flow of funds from MCC to accountable entities to implementing agents and sub-agents clearly documented?
- If funds will not be fully expended by compact maturity, has the disposition of financial assets by

the end of the compact period been finalized in accordance with the MCC policy on Financial Intermediation Activities and Instruments Extending Beyond the Compact Termination Date?

- Have all costs, risks and timelines for initiating, running and closing the initiative been properly estimated?
- Have performance indicators been identified which can effectively track progress of the initiative and is the data sex-disaggregated whenever possible?

Consultative Process/Country Ownership

- Does the proposed initiative provide evidence that it is the outcome of a broad collaborative approach among all stakeholders?

Donor Coordination

- Have other donor, NGO and governmental-funded financial sector initiatives been reviewed to ensure proper coordination and non-overlap?
- Is the proposed initiative part of the country's national strategy and/or congruent with the country's Poverty Reduction Strategy Paper (PRSP)?

Will the initiative accomplish the stated developmental challenge?

Project Design

- Does the initiative address a key developmental challenge (a major impediment to economic growth and poverty reduction)?
- Is the initiative likely to resolve or make considerable progress in resolving that developmental challenge?
- Has the developmental challenge been effectively defined?
- Does the proposal provide a full consideration of the alternatives, and does it document why the proposed initiative is the optimal (least cost and most effective) option?
- Are the goals of the initiative clearly stated?
- What are the proposed activities/inputs which will be undertaken through the initiative?
- What are the expected outputs which will result from the proposed activities and how likely is it that they will be achieved?
- What are the expected outcomes which will result from the initiative, and how likely is it that these outcomes will be achieved?
- How likely is it that the proposed outcomes from the project will overcome the identified developmental challenge, and is this manifested in the economic logic (rate of return)?
- Do the proposed interventions support and link to other elements of the compact?
- Is the size of the proposed initiative appropriate to the target set of beneficiaries?
- Have private sector alternatives been explored to ensure no 'crowding-out' of the private sector in the subject area?
- Has a set of measurement indicators been developed which can track progress against expected objectives, with relevant data sex-disaggregated?

Implementation, Oversight and Budget

- Who is the identified implementing agent?

- How likely is it that the implementing agent will be able to effectively execute the initiative?
 - Is the implementing agent genuinely committed to the initiative?
 - Does the implementing agent have the capacity to manage and report effectively?
- If there are sub-agents (for example, banks involved in on-lending programs), how likely is it that the sub-agents can effectively execute?
 - Is there strong interest in participation in the initiative?
 - Do the sub-agents have the capacity to manage and report effectively?
- How likely is it that the accountable entity oversight body entity will be able to effectively oversee the implementing agent?
- Is the proposed budget sufficient to fund the proposed activities?
- Is the proposed timeline (including intermediate results, milestones and deliverables) reasonable?

Legal and Regulatory/Enabling Environment

- Are there legal and regulatory constraints which will impair the effectiveness of the initiative?
- Do any legal/regulatory constraints particularly impact the ability of vulnerable groups such as women and youth to participate and benefit from projects?
- If so, what measures will be taken to ameliorate any relevant legal and regulatory impediments to the success of the initiative?

Supply, Demand and Accessibility

- Is there strong demand for the products or services proposed to be delivered through the initiative?
- Are the proposed products/services to be delivered not otherwise available?
- What is the likelihood that the targeted beneficiary group will be able to access and use the products and services?

Incorporating Best Practices and Lessons Learned

- Does the proposed initiative reflect international best practices and have proposed activities been shaped by lessons learned from past projects?

PSD Best Practice Guidelines

In performing due diligence of PSD initiatives the following guidelines should be applied to ensure that the initiative as finally proposed incorporates PSD lessons learned and best practices. This section includes general requirements which provide a lens through which any and all PSD proposed initiatives should be reviewed. It also provides specific requirements which provide best practices in specific subject areas, such as in the areas of access to credit and legal and regulatory reform.

General Requirements

Economic Growth and Poverty Reduction

The proposed initiative should provide compelling evidence that the identified development challenge is a key constraint to poverty alleviation through economic growth. It should clearly demonstrate how the

proposed initiative will overcome that challenge, and how this will result in growth and poverty reduction. It should incorporate an economic rate of return analysis per MCC policy, and should include a clear and justifiable underlying logic for the calculation.

In many cases, proposed PSD initiatives will tie in with and/or augment other MCC investments. If so, clear linkages must be made between the overarching compact objectives and how the PSD initiatives will support them.

Sustainability and Subsidies

The proposal should address whether the proposed initiative will be sustainable following the end of the compact. All PSD initiatives do not necessarily need to be sustainable some may have a specific purpose and intended life if intended to address a market failure or severe market distortion. If the initiative is not intended to be sustainable, it should identify the rationale as to why this is acceptable.

The proposal should address whether the initiative relies on subsidies, partial guarantees or other forms of intervention in the market. If so, it should discuss the rationale for the subsidy and/or intervention, and should identify and document any deviance from World Bank OP 8.30. Subsidies may be appropriate if they are: (i) economically justified; (ii) transparent, targeted and capped; and (iii) do not create unfair competition.

Social and Environmental

The proposal should address MCC's social and environmental requirements and explain how the initiative will comply with MCC's social and environmental policies.

Fiscal Accountability

The proposal should describe the flow of funds from MCC to accountable entity to implementing agents and sub-agents, and explain how these funds will be monitored and audited. Where possible the flow of funds should be shown in graphic form. The proposal should describe the how disposition of financial assets at the end of a compact period (if any) will comply with MCC policy. The proposal should address how the costs, risks and timelines for initiating, running and closing down the initiative were estimated.

Consultative Process/Country Ownership

The proposal should describe how the initiative was developed in light of the MCC requirement for a broad, collaborative process. The proposal should address how this process was undertaken, and how it has culminated in the proposed initiative.

Donor Coordination

The proposal should demonstrate a strong understanding of previous and on-going donor PSD initiatives. The proposal should demonstrate that it has been developed in consultation and coordination with other donor, NGO and governmental PSD sector initiatives and should incorporate lessons learned from those

initiatives. It should integrate with those activities and present a plan for on-going coordination. As part of due diligence, a synopsis of other donor, NGO and government PSD initiatives should be included.

Project Design

The project design should clearly articulate the development challenge which the initiative is designed to address, why the developmental challenge identified is critical, and what proposed activities will be undertaken through the initiative to meet the development challenge. It should identify the outputs which are expected to result from the inputs and show the linkage between inputs and outputs (how does the former accomplish the latter). It should address the expected outcomes (the end result of the initiative), the likelihood of the expected outcomes being achieved, and the ways in which outcomes will be measured (sales growth, amount of loans outstanding, value of exports, etc.). Finally, it should demonstrate a clear linkage between the expected outcomes and the developmental challenge how the proposed outcomes are expected to overcome the identified developmental challenge.

There are three general baskets of PSD assistance instruments: (i) Financial Support (loans, grants, credit guarantees, equity investment); (ii) Advisory Services (technical assistance and training); and (iii) Enabling Environment Strengthening (legal and regulatory, investment climate). Most successful PSD projects provide an integrated package of these three elements, building upon the various initiatives which may already be in place.

Risk need to be identified and, to the extent possible, mitigation strategies should be documented and built into the program design. Risks to be considered include not only the risk that a program has unintended consequences (e.g. a higher loss rate than anticipated) but also the risk that demand for the product is significantly higher or lower than the assumed level of demand.

Due diligence should discuss whether the proposed initiative will duplicate other private sector funded initiatives. Generally, MCC will not support activities which result in ‘crowding-out’ of the private sector. Given the size of the MCC footprint, however, the proposed PSD initiative may be able to perform an organizing role in harmonizing the many smaller PSD initiatives which are likely to be in place.

Due diligence must show how (to the extent possible) the initiative is coordinated with other initiatives proposed within the compact. The proposal should provide a means of measuring progress, including a baseline (starting measurements) and performance indicators that are sex-disaggregated, to the extent possible, and reported on a periodic basis.

Implementation, Oversight and Budget

The proposal should address how the initiative will be implemented, overseen and funded. It should identify who the implementing agent is proposed to be and in what ways the implementing agent is qualified for that role.

If there are sub-agents (for example, banks involved in on-lending programs) it should address how those sub-agents will be selected. The proposal should address how determination will be made of the

effectiveness of the sub-agents to serve as financial intermediaries and to manage and report effectively. The proposal should address the proposed budget and demonstrate that it is sufficient to fund the proposed activities.

Cost estimates may be difficult to assess because of different cost structures of potential providers. For example, the costs of a technical assistance provider based in Europe may be different than for a US-based provider because of exchange rates, transportation costs, and wage scales. Budgets should generally assume a relatively high-cost provider so as not to under-fund projects.

Legal and Regulatory/Enabling Environment

The proposal should discuss the overarching environment in which the initiative will occur and any factors therein which will have an impact on the success of the initiative. This will include the legal and regulatory environment (e.g., legislation supporting enforcement of property rights, the capacity of the courts to enforce this legislation, ambiguity or inequality in regards to women's rights to own land or access credit) and the overall enabling environment (e.g., employment flexibility, restrictive labor laws that bar women from working after certain hours or in certain industries, constraints to transfer/export of products).

Supply, Demand and Accessibility

The proposal should address the demand for the products or services which are proposed to be delivered through the initiative. It should address whether the proposed products and services to be delivered are available in the market place, and if not, why not. If the products and services are available, it should address whether the initiative will be duplicative, and if not, what will be different.

It should address the ability of the targeted beneficiary group to access the products and services, and in the case of credit programs, the physical access of beneficiaries to financial institutions.

Incorporating Best Practices and Lessons Learned

Due diligence should address how the proposal incorporates lessons learned and best practices, where possible drawing from the results achieved by similar initiatives.

Specific Requirements: On-Lending Initiatives

Is the identified development challenge a key constraint to poverty reduction through economic growth?

Broadly speaking, private sector enterprises are affected by three factors: (i) demand for their goods and services, (ii) the business environment in which they operate, and (iii) the way in which they respond to market opportunities. The ability of firms to respond to market opportunities is strengthened when they can access credit. But care must be taken to distinguish among differing circumstances in which access to credit might be cited as the problem. Low levels of lending may be attributable to appropriate risk aversion on the part of lenders, market distortion or failure, or to a lack of suitable demand. Efforts should

be made to ascertain the specific causes of the problem so that the root causes can be addressed along with the symptoms.

Will improving access to credit provide a credible solution to the developmental challenge?

If access to credit is determined to be a key constraint, assessment should be undertaken as to whether the initiative as proposed will be effective in solving the developmental challenge in light of the framework identified above (demand for good and services, business environment and firm response). In general, financial services in most developing and transitional economies do not adequately serve the needs of small and growing businesses. However this is usually less a function of supply (liquidity) and more of a problem of insufficient intermediation skills, weak enabling environment and inappropriate credit instruments, among other possible factors. As such, program design should take into consideration: (i) the beneficiaries who should benefit from the program; (ii) the enabling environment in which the program will be implemented; (iii) the proposed intermediaries who will implement the access to credit programs; and (iv) the financial instruments to be used.

Beneficiaries and Demand

The perception of a financing gap may mask fundamental problems at the firm level or within the enabling environment. To what extent does demand for credit outstrip supply, and what is the cause? Is it an issue of pricing, extreme risk aversion on the part of lenders, the legal and regulatory environment, lack of acceptable credit proposals, or a combination thereof?

If a financing facility is proposed, documentation should be provided that the size of the facility proposed is appropriate to the target set of beneficiaries and within the capacity of the institutions which would act as financial intermediaries. Where specifically is the unmet demand which is the specific target audience?

Consideration should be given to developing the capacity of the beneficiaries to act as effective borrowers. Increasing financial literacy may result in stronger proposals, thereby lowering transaction costs and risk premium.

Programs which offer mentoring/advisory services in conjunction with other forms of supply-side support to financial intermediaries seem to have greater success. To what extent are or should business advisory services be available to potential beneficiaries as part of the program?

The most important test of whether an intervention will be successful is whether beneficiaries will exploit it. It is important to assess what obstacles may exist from the perspective of the targeted beneficiaries, e.g. literacy, lack of familiarity/trust with financial intermediaries, cultural attitudes toward debt, etc.

Enabling Environment

A review of the system of contract enforcement and dispute resolution should be done to assess whether attention needs to be extended to reforms that may influence the extension of private credit. The World Bank's "Doing Business" reports generally provide insight as to whether non-credit issues explain access to

credit problems.

For example, it is often difficult in emerging markets to perfect a security interest in collateral, and to enforce that security interest in the event of default. Insolvency procedures are often unreliable and subject to judicial discretion. In some cases this can be mitigated through the introduction of secured lending/commercial finance techniques in combination with the introduction of a pledge registry for movable property.

Accurate information is also a universal problem in developing countries. Accounting and auditing practices are often weak, and credit information is often difficult to obtain.

In addition, certain barriers in the legal and regulatory environment may prevent women from accessing credit, such as unequal access to property in a collateral-based banking system. An assessment of such potential barriers should be made, and potential solutions recommended to remove any existing gender barriers.

Intermediaries/Implementers

In most cases, supporting existing financial institutions (on-lending) is preferable to creating stand-alone SME credit programs. However this will depend upon the capacity of the proposed participating financial institutions in some instances, de novo special purpose institutions have been instrumental in fostering competition and providing lighthouses for other institutions.

Attention should be given to the credit culture of the proposed financial intermediaries. While losses are to be expected, programs should not be supported if it is unlikely that losses cannot be stabilized at an acceptable level before the end of the compact period.

The capability of a small financial institution, e.g. an MFI, to deliver new financial instruments should be carefully questioned. Interviews with such intermediaries are necessary to determine both their willingness to participate, their capacity to underwriting effectively, and whether additional capacity building efforts may be required. Consideration needs to be given to how intermediaries have performed in other donor programs and their ability to file reliable reports in a timely manner.

Criteria need to be in place to determine which financial institutions are eligible to participate. Interviews with regulators, when available, are important to make sure that financial institutions that are on watch lists are not included as participants unless special controls are added.

If institutional strengthening is proposed, documentation should be provided showing how the provision of technical assistance to financial institutions or regulators will support the creation of a stronger credit culture, increased competition within the financial sector, improve regulation, or otherwise strengthen the financial sector.

Flexibility should be maintained to adjust program terms during the compact period to respond to actual loan or guarantee loss experience. In identifying participating financial institutions, care should be given

to ensuring broad geographic coverage and the ability of beneficiaries to physically reach financial institutions and vice versa. If this problem is not addressed, high delivery costs may make a project unrealistic.

Instruments/Initiatives

Consideration should be given to the credit instruments which will be offered. Banks in developing countries will often lend only on the basis of real property (land and buildings) and/or on personal guarantees, which has the effect of excluding poor applicants and female applicants with good ideas but limited collateral.

Tenor is a particular problem in most developing countries banks are rarely willing to lend on a medium to long term basis (2-5 years). Few investments are likely to have a repayment horizon which can be met on a short-term basis. A common problem for SMEs is a lack of financing for SMEs above the micro-finance level and below the level at which commercial banks generally show interest. Attention should be given to requirements for funding with regard to both size and term.

Inclusion of subordinated or quasi-equity instruments should be considered (e.g., preferred stock, debt with warrants). But such instruments need to be reviewed to determine if they can be easily understood by providers as well as beneficiaries and should require minimal legal documentation.

What are the alternative credit instruments with which the proposed activity would compete? MCC project should not dissuade other private sector entrants, including MFIs, in a meaningful way.

Is the proposed initiative properly structured?

Fiscal accountability concerns are particularly high in on-lending programs because of the potential for corruption and capture. Too often, beneficiaries have seen on-lending programs as grant programs in disguise with resulting low rates of repayment.

Oversight/Accountability

Procedures for the flow of funds from MCC through accountable entity to financial intermediaries must be understood and documented. Proper auditing and monitoring procedures should be established within the proposal.

Estimated budget and timeline

The proposed timeline should demonstrate the ability to accomplish the intended initiative within the compact period (with the ability of access to credit programs to extend beyond compact-end).

Impact measurement and results indicators

The proposal should document the intended impact from the initiative and the intermediate indicators by which results will be measured. In access to credit programs, indicators may include:

- Loan disbursement
- Revenues
- Job creation

Compliance with MCC gender and environmental requirements

The proposal should document that the initiative will comply with MCC guidelines:

- Analyze particular barriers that women may face in accessing credit. This includes examining legislation and regulations that may create special barriers for women, such as collateral requirements, loan co-signatory requirements, discriminatory bank practices, weak or non-existent credit registries that do not capture women's repayment records in microfinance, and women's lack of financial and business management skills that may result in lower ability to comply with bank requirements during the loan application process.
- Design programs that support women's ability to access credit in all forms (geographic, business line, funding). This includes, among others, addressing issues identified in the above analysis by adjusting collateral requirements, reforming discriminatory regulations, and tailoring training activities to women.
- Loan eligibility criteria prohibit loans for banned pesticides and chemicals in accordance with partner country standards and MCC environmental guidelines.

Will the proposed initiative be sustainable?

In general, access to credit programs should be designed to be sustainable; however in some instances (market failure) such programs may be structured on a special purpose basis. Subsidizes can be appropriate so long as they are highly targeted, fill a specific market need, and are not intended to be perpetual.

Sustainability of participating institutions and transfer to skills

Consideration should be given to the credit culture (underwriting and portfolio management skills) of participating institutions. In almost all cases, on-lending programs should include a technical assistance component to transfer credit/risk management skills to participating institutions.

Particular attention should be given to the selection of participating institutions with regard to capital adequacy and the ability to absorb losses.

Use of subsidies

Subsidies can take multiple forms. Interest rate subsidies that are directed at intermediaries as an inducement are more acceptable than subsidies directed at end users (borrowers), but should in any case be tested to determine the extent to which they might dissuade private sector participation in the same activity.

Subsidies may be used as an inducement in selected circumstances to draw financial institutions toward new market segments or regions. Such subsidies might include full or partial reimbursement of operation

costs for a short period of time. However, such subsidies are appropriate only when there is a likelihood of sustainability when these inducements cease.

Partial guarantee structures that guarantee intermediary losses in excess of 50% should generally be rejected as carrying too high a degree of moral hazard. Partial guarantee programs may be used when there is judged to be a difference between lenders' perceived risks and actual market risk. However, in such cases, technical assistance will usually be required to upgrade credit analysis and risk management skills so that market activity will persist beyond the end of the guarantee program.

Transition plan

MCA counterparties should be aware of the MCC policy with respect to the disposition of financial assets at the end of a compact period, and (if so intended) the proposal should document how the proceeds from the initiative will be transferred and tracked

Is the proposal coordinated with other Private Sector Development initiatives as well as other elements within the compact?

It is likely that there will be several other micro-finance and/or on-lending programs in place. As such, it is particularly important that the MCC funded program compliment and not compete with other programs. In addition, MCC on-lending initiatives should be developed in harmony with other compact initiatives to as to leverage compact impact.

Coordination with other donor/governmental initiatives

Most developing countries have numerous micro-finance programs and many have SME on-lending facilities. Proposals should ensure that these programs are identified, and that pricing and terms on these programs be roughly comparable.

On-lending proposals should show how the MCC funded program will be uniquely targeted and not simply additive. Due diligence should address consultations held with all the key donors and NGOs and document the outcomes of these meetings.

Coordination with other compact initiatives

Generally on-lending programs will be structured to support other compact components focusing on rural or SME development. Care should be taken to consider areas of overlap with these activities to align the geographic coverage and take into consideration other donor programs operating on the same population or area.

The sequencing of activities should be consistent with the sequencing and timelines for the activities that the financial sector intervention is expected to support.

Specific Requirements: Legal and Regulatory Reform

Is the identified development challenge a key constraint to poverty reduction through economic growth?

The legal and regulatory environment in which businesses must operate is a critical factor in private sector development. That said, more often than not legal and regulatory reform initiatives are likely to be elements within initiatives rather than overt stand-alone initiatives.

In compact initiatives in which legal and regulatory reforms are proposed, the proposal should clearly document the intended benefit of such reforms in terms of economic impact. If legal and regulatory reforms are proposed as a sub-activity within another activity, the proposal should reflect what the impact will be if the reforms are not accomplished.

Is the proposed initiative a credible solution to the developmental challenge?

In order to have the intended impact, legal and regulatory reforms must not only be embodied as changes in law, but embodied in the overall legal, economic and social fabric as well. For example, if the proposed activity is primarily focused on improving the operations of courts, it may also be concerned with upgrading other related components in the legal system (e.g., private bar, law schools, lawyers in government agencies), to avoid uneven progress in the system.

Beneficiaries and Demand

The proposal should document how the intervention will overcome the identified impediment from the practical perspective of the beneficiary.

Enabling Environment

The proposal should address the overarching enabling environment, particularly related policies, laws, regulations and procedures. This is the water in which the activity swims or drowns. For example, if an initiative aims to build courts to improve access to justice, it must also consider all of those aspects beyond bricks and mortar issues of capacity building, dissemination of information, and case management to note just a few.

Implementation

Laws and regulations are implemented through the justice system, and the proposal must document how legal and regulatory changes will be implemented and enforced. For example, several developing countries have adopted modern bankruptcy laws; however the judicial system commonly refuses to enforce such laws as a matter of social custom.

Is the proposed initiative properly structured?

The proposal should describe the flow of funds as well as oversight. MCA counterparties should be aware that if governmental entities will be implementing the initiative, there are particular limits to what MCC can support (i.e., goods or outside consultants are permissible, but salaries or other payments to government officials are not). The proposal should provide some sort of starting measurements, whether

our goal is to speed the resolution of commercial disputes, or increase the number of labor disputes that are addressed through mediation.

Impact measurement and results indicators

Indicative indicators for legal and regulatory reform achievement might include:

- the speed the resolution of commercial disputes
- The increase the number of labor disputes that are addressed through mediation.

Compliance with MCC gender and environmental requirements

The proposed activity should support women's access to justice, legal services, or other law-related services. The activity should promote broader access to legal services, particularly to disadvantaged groups, and not just expand services to groups (such as business owners) that may already have greater advantages than ordinary citizens.

Geographic issues should be documented in the proposal the initiative should have significant impact beyond merely the capital or major cities.

Will the proposed initiative be sustainable?

In the case of legal projects particularly, sustainability may largely depend on government budgets, rather than increased revenues, as well as sustained political will.

Sustainability of participating institutions

The proposal should document the commitment of the government to fully fund legal and regulatory reform initiatives, as well as the likelihood that the policies, laws and regulations be made and implemented on a consistent and transparent basis.

Consideration should be given to whether there is a personal or political dynamic that prevents or corrupts change or is not being harnessed to promote change.

Transfer of skills

With initiatives which will require a new set of skills or expertise, the proposal should document how training/skills transfer will be executed. Where skills transfer is proposed, it should identify how the persons responsible for policy and implementation with respect to the activity will gain the knowledge they need to make good decisions and implement them.

Is the proposal coordinated with other Private Sector Development initiatives as well as other elements within the compact?

It is particularly important that proposed legal and regulatory reform initiatives emerge from a true consultative process, and are coordinated with other legal and regulatory/judicial reform initiatives.

Coordination with other donor/NGO/governmental initiatives

The activity should evidence input from all relevant legal groups (government, judiciary, private bar, academia, law-related NGO's, women's legal and advocacy groups) as well as non-groups private business, civil society, and others.

Coordination with other compact initiatives

In virtually all cases, legal and regulatory reforms will coordinate directly with other compact initiatives. The proposal should make a clear linkage between the activities and the intended cause and effect.

Monitoring and Evaluation of MCC Compact Projects

Immediately following a country's compact eligibility determination, MCC's Monitoring and Evaluation Division will begin due diligence on the proposed investments, with a particular engagement with early stage concept notes by project leads. Below are examples of questions which are pursued during the due diligence phase. The list of specific questions may be edited if appropriate.

Monitoring

Goals and Objectives

- Are the goals and objectives measurable and clearly articulated?
- Are beneficiaries quantified and demographic characteristics described?
- Is Program design logically related to the Goals?

Indicators to measure progress towards Program Goals (poverty reduction measure)

- Are the indicators consistent with economic analysis?
- Are the indicators credibly linked to Goals and Objectives?
- Are the indicators easy to understand?
- Are the indicators consistent with those used by other actors involved (if relevant)?

Indicators to measure progress towards intermediate outcomes

- Do the intermediate indicators track progress at compact objective and individual activity levels?
- Can the intermediate indicators be reliably measured and can data be cost-effectively collected (relative to information value)?
- Are the intermediate indicators limited in number so as to include only the most crucial indicators?
- Are the intermediate indicators consistent with economic analysis?
- Are the intermediate indicators credibly linked to poverty reduction indicators described above?
- Are there some indicators can be used to condition disbursements?
- Are the intermediate indicators consistent with those used by other actors involved?

Data Source

- Does the M&E plan use existing data sources?
- If new data collection is required, is there a broader use beyond MCA program monitoring?
- Is baseline data available? If not is there an agreement on the plan to collect baseline?
- Which data collection agency will be responsible for tracking each indicator? What is the measurement unit, method, and frequency of data collection?
- Will data be disaggregated by gender, income group, age, or ethnicity where relevant?

Targets for all indicators or plan to establish targets

- Are targets consistent with the economic growth analysis (as applicable)?
- Are there annual and final targets?

- Do targets take into consideration natural rate of growth (as applicable)?

Reporting Schedule

- Is the reporting schedule consistent with planned disbursements?
- Is there a plan for public dissemination of program performance?

Evaluation

Assessing an investment's evaluability

- Is the problem clearly understood and identified? Are there baseline data available for the project which makes the case for this problem?
- Is the program scope and casual logic clearly defined, linked to economic analysis and program goal?
- Are the program results plausible and measurable within a reasonable time frame?
- Are the beneficiaries and location(s) of impact clearly defined?

Determining the ideal evaluation method

Three key questions help determine the relevance of an *impact evaluation* methodology:

- Need: Would future MCC investments be informed by the results of a potential impact evaluation?
- Might the results of an impact evaluation be relevant to future MCC investment?
- Is there a lack of rigorous literature which answers the questions being asked during compact development?
- Cost-effective Learning: Would an impact evaluation yield information whose added value to policymakers justifies the cost?
- Can relevant impact data be obtained at a reasonable cost?
- If data collection costs are relatively high, will the data be beneficial in other areas of the compact (other evaluations, monitoring uses, etc.) or are they narrowly useful for the impact evaluation?
- Are stakeholders interested in answering the evaluation questions of an impact evaluation?
- Is there a project stakeholder willing to champion the impact evaluation?
- Feasibility: Is a contracted impact evaluation likely to lead to credible, actionable findings?
- Can a statistically valid counterfactual be used to isolate and attribute results to the project?
- Is the "control group" a reasonable counterfactual of what might occur without this MCC intervention?
- Does the rigorous design allow for adaptation of the project according to the changing needs of the project? If not, have the specific restrictions in the design (e.g. control group preservation, cutoff selection mechanism in RDD, treatment replacement plans, etc.) been communicated to the project team?

In the event that the above questions indicate a low probability of completing a useful, cost-effective impact evaluation for the activity in question, an independent performance evaluation should be planned.

- Has a particular performance evaluation methodology been determined? (See Performance Evaluation guidelines for more information)
- Is there quantitative data which would give an independent evaluator leverage by which to evaluate

an activity's outcomes?

- Are performance criteria (including program logic) stated in official documents and agreed upon by project leads?

Evaluation implementation

- Will the independent evaluator be contracted by MCA or directly by MCC?
- Is there a tentative timeline for evaluation activities during years 1 to 5 of the compact?
- Does the implementation timeline take into account procurement requirements (plans for contracting a design/implementation evaluation firm/individual and any data collectors)?
- What data will be used for evaluation (include source, frequency of collection, and party responsible for contracting and managing data collection)?

Other M&E planning guidelines

Data Quality Reviews

- Are there procedures for assuring data quality?
- Are data quality reviews timed to address capacity issues early in compact term with regular reviews throughout compact term?

Assumptions and Risks

- Do assumptions include factors that influence the projected benefits of the program, but are not directly addressed by the program?
- Are assumptions and risks consistent with economic growth analysis?
- Is there a plan to mitigate risks where feasible?

Multi-year M&E budget

- Does the M&E costs estimate include funding in compact and any direct MCC M&E funding to be used?
- Do line items take into account all potential costs and contingency costs?

Staffing Plan

- Are there descriptions of the roles and responsibilities of the M&E director and other staff?
- Is there a staffing plan that describes the role of in-house staff, outside consultants, independent evaluators?
- Has a country counterpart for economic analysis and M&E been hired/appointed?
- Does the counterpart have a strong Economics/Statistics background?

Plans for making M&E reports and evaluations publicly available

- What are the plans for making M&E reports available on the country website?
- Is there a need for other methods of dissemination?
- How will civil society, advisory groups, and/or beneficiary groups be involved?

Country capacity to implement the M&E Plan

- Is there capacity in country to implement M&E Plan?
- Has this been confirmed by other donors or qualified entity?
- Are there plans and budget for providing technical assistance to address current or future weaknesses in implementing the M&E Plan (as needed)?

Working Sessions

- Do Country team and MCC team agree on the economic and program logic (links between the program components and poverty reduction objectives)?
- Was there broad participation in the economic analysis and the M&E Plan (especially by potential implementers and technical specialists)?
- Is there a plan for stakeholder or beneficiary consultation?

Other donors involved in statistical capacity building and data collection

- Where relevant, is performance measurement coordinated and/or consistent with that of other actors?
- Are MCC funded activities are consistent with national plan for statistics?
- Are capacity-building efforts are coordinated or consistent with other actors?

Endnotes

1. Millennium Challenge Act of 2003, Section 602.
2. Many studies have investigated the relationship between economic growth and poverty, and while MCC does not favor any particular one, readers interested in evidence from the 1990s may consider “Pro-poor Growth in the 1990s: Lessons and Insights from 14 countries,” available online at http://siteresources.worldbank.org/INTPGI/Resources/342674-1119450037681/Pro-poor_growth_in_the_1990s.pdf.
3. Readers may be familiar with benefit-cost analysis, and ERR estimates represent a summary statistic that reflects the economic merits of a proposed investment. A project is considered a sensible economic investment when the estimated ERR is higher than the local discount rate for capital. In most developing countries, one would expect that discount rate to be near or above 10%.
4. Although MCC’s primary objective is reducing poverty through growth, the impact on equity is a related and important consideration. It is possible that a high-return project could increase inequality but still deliver large amounts of income to the poor; it is also possible that a project targeted to the poor could reduce inequality but, because of low returns, deliver few benefits to the poor. The Beneficiary Analysis should help program planners avoid both of these outcomes, recognizing that poverty impact is driven by the total *amount* delivered to the poor.
5. Value-added is defined as total revenues minus the cost of intermediate inputs. It is the measure of the economic output of an enterprise that is used in national income accounting. The value-added of each firm flows back into the hands of the firm’s individual owners and employees in the form of profits and wages.
6. When proposals are not amenable to micro-economic growth analysis (as might be the case, for example, in policy reforms that are national in scope), MCC seeks to measure the impact by regression evidence from other countries or cross-country regression analysis or by use of simulations based on realistic assumptions.
7. In such an analysis, an ERR of 0% does not describe a project whose costs and benefits are equal, but rather a project whose costs and benefits are equal only if capital has no opportunity or time cost. In traditional benefit-cost analysis, the net present value of an investment is positive if the ERR is higher than the discount rate.
8. **Public goods** are goods or services that can be consumed by several individuals simultaneously without diminishing the value of consumption to any one of the individuals. This key characteristic of public goods, that multiple individuals can consume the same good without diminishing its value, is termed **non-rivalry**. Nonrivalry is what most strongly distinguishes public goods from private goods. A pure public good also has the characteristic of **non-excludability**, that is, an individual cannot be prevented from consuming the good whether or not the individual pays for it. For example, fresh air, a public park, a beautiful view, national defense.
9. Important rent transfers should be noted elsewhere in the analysis when seen to be significant.
10. The opportunity cost is the highest valued alternative foregone in the pursuit of an activity.
11. In the field of international development, discount rates of 10-12% are commonly used. MCC’s hurdle rate of 10% is consistent with this industry standard.
12. This analytical approach assumes that higher household income leads to higher consumption levels for all household members, but does not assume that all household members benefit equally. This assumption is consistent with evidence that the welfare of household members of all types improve as household income rises.
13. Best practice suggests using household consumption data to classify poverty ratings. In some cases where accurate consumption data may be difficult to obtain, income measures may be useful substitutes with appropriate adjustments. Purchasing power parity (PPP) adjustments are made in

terms of 2005 international dollars, consistent with the World Bank's most recent estimates of poverty lines in developing countries.

14. The "poor" category of beneficiaries includes the "extremely poor," as there is little practical use for statistics referring to those consuming *between* \$1.25 and \$2 per day. As a result, however, the entire population is included in the three groups: poor, near poor, and not poor.
15. Such data are generally available from existing sources, such as reports based on national household income and expenditure surveys, agricultural or enterprise surveys, Demographic and Health Surveys (DHS), or World Bank-supported Living Standards Measurement Surveys (LSMS).
16. If the population living under \$2 per day accounts for 25% of national consumption expenditures, that same population could be expected to gain 25% of the benefits of a distribution-neutral investment.
17. The presentation of these examples does not suggest necessarily that MCC approves of these projects. Some of the numbers used are estimates for purposes of illustration. Some numbers are deliberate simplifications of a more complex reality.
18. The program is named Progresa and has been extensively studied and documented. For an account that summarizes a lot of the results and research, see Morley, Samuel and David Coady, *From Social Assistance to Social Development: Targeted Education Subsidies in Developing Countries*. Center for Global Development, Washington DC, September 2003.
19. For example, Caldes and Maluccio (2005) estimate that the annual administration costs of previous conditional cash transfer programs have been as high as 60% of the transfer amounts.
20. For a detailed survey of CCT studies, see Fiszbein, Ariel et al, *Conditional Cash Transfers*,; World Bank Policy Research Report, 2009.
21. See Thomas, Duncan, *Health, Nutrition, and Economic Prosperity: A Microeconomic Perspective*,; Commission on Macroeconomics and Health Working Paper No. WGI: 7 May 2001.
22. Kremer, Michael and Edward Miguel, *Worms: Education and Health Externalities in Kenya* Poverty Action Lab Working Paper No. 6, September 2001.

Reducing Poverty Through Growth

